PRESIDENT'S ECONOMIC GROWTH PROPOSALS

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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COMMITTEE ON WAYS AND MEANS

BILL THOMAS, California, *Chairman*

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TUESDAY, MARCH 4, 2003

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 2:05 p.m., in room 1100 Longworth House Office Building, Hon. Bill Thomas (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
February 25, 2003
FC–5

CONTACT: (202) 225–1721

Thomas Announces Hearing on President's Economic Growth Proposals

Congressman Bill Thomas (R–CA), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a four-part hearing to examine the economic growth proposals included in the Administration's fiscal year 2004 budget. **The hearing will take place on Tuesday, March 4, 2003, at 2:00 p.m.; Wednesday, March 5, 2003, at 2:00 p.m.; Thursday, March 6, 2003, at 10:00 a.m.; and Tuesday, March 11, 2003, at 2:00 p.m. All segments of the hearing will take place in the main Committee hearing room, 1100 Longworth House Office Building.**

In view of the limited time available to hear witnesses at the hearing, oral testimony will be heard from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee or for inclusion in the printed record of the hearing.

BACKGROUND:

The Administration's fiscal year 2004 budget includes provisions providing individual income tax relief and promoting long-term economic growth. The proposal would accelerate provisions that were enacted by the *Economic Growth and Tax Relief Reconciliation Act of 2001* (P.L. 107–16), including the expansion of the 10-percent income tax bracket, the reduction in the individual marginal income tax rates, marriage penalty tax relief, and the increase in the child tax credit from $600 to $1,000. In addition, the proposal would increase the amount of investments that small businesses can expense annually pursuant to section 179 of the Internal Revenue Code. Finally, the proposal would reform the taxation of dividends. The hearing will examine the economic effects of these proposals.

In announcing the hearing, Chairman Thomas stated: "The President's proposal seeks to put the economy back on track for solid, job-producing growth. The hearing will provide the Committee with a chance to explore all aspects of the President's proposal."

FOCUS OF THE HEARING:

Witnesses will be asked to discuss the potential economic consequences of the Administration's economic growth proposals. As tentatively scheduled, the first segment of the hearing will include testimony from the Administration and from economists regarding the effects of the overall package. The second segment of the hearing will focus on individual income tax relief proposals in the package. The third segment of the hearing will focus on the proposal to eliminate the double taxation of corporate dividends and the proposal to expand small business expensing. Finally, the fourth segment of the hearing will provide Members of Congress with an opportunity to testify.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to (202) 225–2610, by the close of business, Tuesday, March 18, 2003.

Those filing written statements that wish to have their statements distributed to the press and interested public at the hearing should deliver their 200 copies to the full Committee in room 1102 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to (202) 225-2610, in Word Perfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at http://waysandmeans.house.gov.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman THOMAS. Good afternoon. Today we will start an examination of H.R. 2, the Jobs and Growth Tax Act of 2003. This bill is an exact rendering of President Bush's proposal to speed up the economy's growth rate while creating jobs and secure futures for Americans. This four-part hearing, which is somewhat extraordinary in itself, will allow us to fully explore the impact and mechanics of the President's proposal so the Members of this Committee can make informed decisions. We need to understand short-term and long-term impacts, the impact on various types of taxpayers and industries and the general effect on economic efficiency. The need to grow our economy to produce stable, lasting jobs and to remain capable of paying the costs of our freedom is urgent and becoming more urgent everyday. Today, we will be hearing from members of the Administration.

The second segment of our hearing will include two panels tomorrow. The first will focus on individual tax relief proposals in the package, and the second panel, which will also be the topic of Thursday's hearing, will focus on the proposal to eliminate the double taxation of dividends.

Finally, we will reconvene for the fourth segment next Tuesday in which we plan to hear from particular Governors and Members of Congress, sharing their ideas with us.

The economy is in a soft spot. Businesses are concerned about both the short term and the future. Sensible and permanent tax changes will improve business confidence and tax rate cuts will increase workers' paychecks. President Bush has offered a proposal to create a single level of taxation on business earnings and proposed marginal tax rate cuts, which is a key element for promoting economic growth by encouraging work, savings, and investment.

We are pleased to have with us today Treasury Secretary John Snow. With him will be Treasury Assistant Secretary for Tax Policy, Pam Olson. The Committee welcomes both of you back and extends its welcome to Richard Clarida, Assistant Secretary for Economic Policy. This is Mr. Clarida's' first appearance, I believe, in front of the Committee on Ways and Means. We look forward to the explanations provided by the Secretary and/or of the appropriate assistant secretary.

With that, I would recognize the gentleman from New York, Mr. Rangel, for any comments he would like to make.

[The opening statement of Chairman Thomas follows:]

Opening Statement of the Honorable Bill Thomas, Chairman, and a Representative in Congress from the State of California

Good afternoon. Today we will start an examination of H.R. 2, the *Jobs and Growth Tax Act of 2003*. This bill is an exact rendering of President Bush's proposal to speed up the economy's growth rate while creating jobs and secure futures for working Americans.

This four-part hearing will allow us to fully explore the impact and mechanics of the President's proposal so that Members of this Committee can make informed decisions. We need to understand short-term and long-term impacts, the impact on various types of taxpayers and industries and the general effect on economic efficiency. The need to grow our economy, to produce stable, lasting jobs and to remain capable of paying the cost of our freedom is urgent.

Today, we will be hearing from members of the Administration. The second segment of our hearing will include two panels: the first one will focus on individual income tax relief proposals in the package; and the second panel, which will also be the topic of Thursday's hearing, will focus on the proposal to eliminate the double taxation of dividends. Finally, the fourth segment of the hearing next Tuesday will provide Members of Congress and Governors with an opportunity to share their ideas.

The economy is in a soft spot and businesses are concerned about both the short-term and the future. Sensible and permanent tax changes will improve business confidence and tax rate cuts will increase worker's paychecks. President Bush has offered a proposal to create a single level of taxation on business earnings and proposed marginal tax rate cuts, which is a key element for promoting economic growth by encouraging work, savings and investment.

We are honored to have Treasury Secretary John Snow and Treasury Assistant Secretary for Tax Policy Pam Olson before us today. The Committee welcomes you back and looks forward to hearing from you. Also joining us today is Richard Clarida [Clare - i - da], Assistant Secretary for Economic Policy. This is Mr. Clarida's first appearance in front of the Committee on Ways and Means, and we look forward to discussing the economic ramifications in H.R. 2's provisions with you, as well.

I now recognize the gentleman from New York, Mr. Rangel, for any comments he would like to make at this time.

Mr. RANGEL. Thank you, Mr. Chairman. Thank you once again, Mr. Secretary. Mr. Clarida, welcome, and Ms. Olson. It is very important, and I thank the Chairman for inviting you to come here, that we try as desperately as possible to see whether or not it is possible to move forward on a bipartisan basis. I think everyone

would agree when you are having dramatic changes in policies, especially tax policies, it is very helpful to the American people to believe that it is not a partisan effort but one that is necessary for our national economic growth. This is especially so when our Nation is on the brink of a possible war and we find unemployment high, local and State governments going to deficit, programs being cut.

One of the concerns that most all of us have is whether or not the sacrifices that are being asked for Americans to make, especially those in the military, whether that sacrifice is going to be shared.

It seems almost unbelievable that at a time of possible war, we are now talking not about shoring up these programs in terms of protection of our young people in the military, but we are talking about a dramatic tax cut that, until we get distribution tables from the Administration, would allow most Americans to believe that only those who are very fortunate economically would benefit from these tax cuts.

So, it seems to me that the fact that the Administration cannot give us any estimates of what it is costing now to support the deployment of troops around the world, no estimate of what it would cost if the President decides to invade Iraq, what it would cost to occupy Iraq or any other place that it decides is necessary in our national interest, it is very difficult for us to be able to digest the suggested tax cut.

You are here and we are anxious to hear from you and I thank the Chairman for giving us this opportunity.

Chairman THOMAS. Thank you very much. Mr. Secretary, any written statements that you may have will be made a part of the record and you may address us as you see fit. Let me indicate to you that these are very antiquated sound structures around here. You need to turn it on, but it is very unidirectional. You need to speak directly into it. Our goal is to improve this Committee room and we will do so over the year, but for now we are laboring in the fifties as far as the sound system is concerned.

STATEMENT OF THE HONORABLE JOHN W. SNOW, SECRETARY, U.S. DEPARTMENT OF THE TREASURY; ACCOMPANIED BY THE HONORABLE PAMELA F. OLSON, ASSISTANT SECRETARY FOR TAX POLICY; AND THE HONORABLE RICHARD H. CLARIDA, ASSISTANT SECRETARY FOR ECONOMIC POLICY

Mr. SNOW. Thank you. I thank you very much for that good counsel on how to use the sound system. I also thank you and Ranking Member Rangel and distinguished Members of the Committee for the opportunity to appear before you today to discuss the President's plan for jobs and growth.

Let me begin, Mr. Chairman, by thanking you for introducing the President's jobs and growth proposal last week. If passed as introduced by you, I am confident that the President's plan will create a lot of new jobs and will put the American economy on a higher growth path, and it will provide for higher standards of living and higher productivity for the American economy.

Why is the plan needed? Well, I think we all know something is needed to give the economy a boost, something is needed to assure that we create those jobs for those who can't find jobs. The President has said he wants to make sure that the economy grows fast enough to assure that everybody who wants a job can find a job, and we are not doing that right now.

The President's plan deals with both the short-term concerns—sustaining the recovery, improving the recovery, and bolstering the recovery—and the longer-term concerns with putting America on a higher growth path, creating higher productivity, deepening the savings pool and capital pool of the country.

I think you all know the plan. I will be brief. In the near term, the plan puts money in consumers' pockets and it does so right away, and this will stimulate demand. It does so by accelerating the tax relief that was approved in the 2001 tax legislation, good tax legislation, legislation that was needed to make sure we didn't fall into a deep recession. I think the tax plan is fair. The tax plan provides broad-based and far-reaching relief for small business, for millions of taxpayers, and reduces tax burdens at the end of this process while it reduces tax rates across the board, produces tax rates at the end of the process where those at the highest income levels actually pay a larger share of the national revenues than they did at the beginning and those in the lower income categories pay a smaller share.

A centerpiece of the plan is the proposal to eliminate the double tax on dividends. I think it is axiomatic that you get less of everything you are taxed. That is why we put tax on things we don't like. That is why we have so-called sin taxes. It strikes me as a bit strange we would want to double-tax the very lifeblood of the economy, capital and capital formation. Can't be any doubt about the fact that double taxation of capital means we have less capital. Means we use more debt. Means we have higher debt-to-equity ratios than we would otherwise. Means the financial structure of companies is more fragile than they otherwise would be, and it means that companies have less incentives to pay dividends.

In this day and age, when there are so many questions being raised about accounting earnings and reported earnings and about GAAP earnings, it seems to me it is a healthy thing to encourage companies to pay more dividends, because after all, dividends reflect maybe in the best and most transparent way possible, the real earning power of the corporations. So both from a short-term point of view and a long-term point of view, from the point of view of putting people back to work now and from the point of view of creating a more prosperous and abundant economy for the long term, I commend this proposal to you and I look forward to responding to your questions.

[The prepared statement of Mr. Snow follows:]

Statement of the Honorable John W. Snow, Secretary, U.S. Department of the Treasury

Chairman Thomas, ranking member Rangel, and distinguished members of the House Ways and Means Committee, it is my privilege to appear before you today to discuss the President's plan for jobs and growth. Let me begin my testimony by thanking Chairman Thomas for introducing the President's Jobs and Growth proposal. I believe that if passed as introduced by the Chairman, the President's plan

will create and secure jobs, accelerate and sustain our recovery, increase workers' standards of living and increase the economic performance of our nation for many years to come.

This plan is needed because too many people who want jobs can't find them, and too many people who have jobs are concerned about their job security. Let me explain.

In the near-term, this plan puts money in consumers' pockets right away, which will stimulate demand. The 10% tax rate bracket will expand immediately; helping low-income earners keep more of their pay. The punitive marriage penalty will end once and for all, and the child credit will increase by $400 to $1,000 per child this year. The plan will accelerate the additional income tax relief approved in 2001, to accelerate the benefits to the American people.

Under the President's proposal this year, a typical family of four with two earners making a combined $39,000 will receive a total of $1,100 in tax relief, compared to 2002—not just this year, but in every year thereafter.

The tax rate cuts will spur business investment in the near term. Much investment and new employment comes from small businesses, most of which are S corporations, sole proprietorships, and partnerships. These businesses are taxed at individual tax rates, so marginal rate reductions help create new jobs and equipment.

Rate reductions combined with the proposed increase in new equipment expensing for small businesses will give our economy a big boost, and quickly. According to this Administration's analysis, our economy will add about 1.4 million new jobs under this plan by the end of next year—that's the best kind of help to a lot of families, who really need it.

As I stated earlier, the President's plan also contains the elements for a healthier, higher-performing economy over the longer-term. A key element of the plan for both fairness and effectiveness is the complete elimination of the double-taxation of dividends. Anything you tax more of, you will get less of, including business investment. Today, corporate profits are taxed at 35 percent range, and then these profits, which represent the return on business capital, are taxed again when paid to shareholders, so that total tax on this money can be as high as 60%.

Taxing anything twice is unfair. It is nothing short of double jeopardy for those who invest in America, and we pay for it with American jobs.

This is a double tax on investment. When you tax investment, you get less of it. That policy is directly opposed to economic growth. Investment is basic to the American economy. We need to encourage business owners to invest for growth. Why instead would we punish those who want to invest in America?

Again, this double taxation is unfair, counter-productive and damaging to our economy. Double taxation makes it doubly difficult for companies to hire new workers, for hardworking taxpayers to save for their retirement, and for the economy to grow and create jobs. For every dollar a business sends to Washington in taxes, it is one less dollar it can spend to hire a new employee, develop a new product or invest in the future. For every dollar an individual taxpayer sends to Washington in the form of a dividend tax, it's one less dollar to invest in a business or save for the future.

Because the President's proposal lowers the cost of capital by reducing the double taxation of capital, it encourages investment and a higher long-term growth rate. Lower capital taxes mean more capital, which means higher productivity, which means faster growth and higher wages for everyone.

Also, ending the double taxation of dividends benefits people who will never receive a penny of dividends, because they will live in a more prosperous economy.

This package is good economics. The President's plan makes the economy more efficient, which raises productivity, which raises real wage rates, which raises the standard of living, which in turn provides more choice, opportunity, security and confidence for the American people.

In addition, dividend tax relief will stimulate the economy by increasing disposable incomes and by raising stock market share prices, inducing a "wealth effect." We are now a nation of shareholders: over half of families own stock shares, many of which pay dividends.

Let me further illustrate the argument. Let's say a family owns 200 shares of a $50 stock with a 3% yield. That means they receive $300 in dividends from those shares each year, but they only keep $200 of that because of the dividend tax. Without that tax, they keep another $100, which they can spend as they please. That means higher consumer spending.

But there is potentially a much larger benefit from higher equity prices and the wealth effect. If our hypothetical company has 200 million shares outstanding, the effect of eliminating the double taxation of dividends is to increase the shareholders' after-tax earnings by up to $100 million. That is, $100 million of dividends that

would have gone to shareholder taxes are now kept by the shareholders. These additional earnings are capitalized into the price of the company's shares, assuming a certain discount rate and earnings multiple, so they might add, say, $1 billion to the market cap of the company. This encourages "wealth effect" spending by the owners, which we saw in great abundance in the last decade, and it lowers the cost of capital for the company.

The President's goal is to do something now that would pay off today and long into America's future—not here today, gone tomorrow. President Bush's jobs and growth plan will not only help American's achieve their economic dreams, creating a more abundant future with more good and secure jobs and rising real wages.

I urge this committee to pass it quickly. Thank you.

Chairman THOMAS. Thank you very much, Mr. Secretary. I know Members are anxious to ask questions and I am going to try to hold Members to the time limit as best I am able. My question will go to the heart of, I think, some of the concerns that many have about the President's proposal, since we have seen many of these very specific pieces before. Most of us are familiar with child credit, marriage penalty, the acceleration of the rates. It is, I think, the dividend proposal that is the one that probably needs some examination.

The way I would ask the question is that you obviously selected, out of some options that could be created, a particular dividend proposal. Could you briefly give us a feel, an understanding, of the choices that you looked at, if there was more than one, and why this one probably offers itself as one preferred to others? I know we get into some details in this and I would be more than willing to allow any of the folks at the panel to discuss it. My hope is at the end of this very brief discussion—and obviously we will get written support to a number of the questions that we ask, because we can't get the full answer in the short time that we have—but this one was chosen, and other ones were not and why, I guess would be the easiest way to ask that question, Mr. Secretary?

Mr. SNOW. Thank you, Mr. Chairman. I wasn't in the Administration when the legislation was—the formative period of this legislation—but I was consulted by people in the Administration and had some conversations with the President on the proposal as well. So I feel that I am vested in the proposal. The key alternative to this proposal, I suppose, would be, on the one hand, lowering rates to 50 percent on dividends or 25 percent on dividends or putting in an exclusion. All of those I am told were under review by the Administration. The President on that score I think concluded that the principle here is awfully important, the principle that corporate income should be taxed once, but just once, and there is no principle to tax corporate income 1.4 times or 1.7 times. I think the Administration thought that through, as I reconstruct what happened. I think the President finally decided the way to do this was, on broad principle, tax corporate income once and not more than once, so it was a principle decision.

An alternative to get at the same issue would be to have made the deduction available to the corporations. There is some merit in that idea. Chairman Greenspan has testified that he thinks it is probably better to do it at the corporate level than at the shareholder level because the impact would be quicker. Corporate executives would respond more immediately to the stimulus. On the

other hand, as I recall his testimony, and he was very supportive of the concept, his testimony was in the end you get to the same place, because the marketplace will drive corporations if the incentives are there to pay the same amount of dividends whether it is excluded at the corporate level or at the investor or taxpayer level. Those were the basic considerations.

Of course, another way to get at the whole question would be to eliminate the corporate income tax. That might overload the boat. Another way to get at it would be to have some major reduction or elimination of capital gains taxes. That probably overloads the boat, too. One consideration in the deductibility at the investor level rather than at the corporate level is cost. It costs less to do it this way.

Maybe Pam or Rich would like to answer it because you were in the Administration at the time this was all done.

Ms. OLSON. The only thing I would add to the Secretary's very good description of it is that there is a definite difference between the deduction at the corporate level and an exclusion at the shareholder level because of the number of shareholders that are tax exempt, exempt organizations, and et cetera. The President's principle was that he wanted to tax income once and only once and he did very much want to deliver this benefit to the shareholders of America.

Chairman THOMAS. Thank you very much. Gentleman from New York wish to inquire?

Mr. RANGEL. Thank you, Mr. Chairman.

Mr. Secretary, the economy is really in bad shape, local and State governments accruing deficits, programs are being cut, and it looks like we are moving more and more in a wartime economy. We are being shaken down by countries around the world in order to assist us in liberating countries in the Middle East. The deficit—interest on the debt is playing a more important role in our budgets. We can't get from the Administration the cost of our troops in Afghanistan and then step up in the wartime effort. I just can't believe that the Congress cannot get any estimate at all as to the cost of what could be a war being declared by our government against the government of Iraq. I can't see how we can talk about a dramatic cut in taxes when we have no clue of the cost of a potential war. It would be different if your proposal was conditioned on whether or not we are at war or not.

Every time we hear war, we hear of sacrifice and I think you are suggesting that this tax cut is not a reward for the wealthy but a reward for all of America. We have a very tight budget that we work with in trying to provide assistance to our constituents.

My question would be, do you have any idea at all what the economic costs of the war would be if, in fact, the President fulfills his recommendation that the United States liberates the people in Iraq? Do you have any ballpark figures to share with us that would make your recommendations of this dramatic reduction of resources make more sense to Members of Congress?

Mr. SNOW. Thank you, Mr. Rangel. You put your finger on a good issue, an important issue. The President really is trying to avoid a war. He says war is the last option here, and he is extending himself and his Administration to seek to avoid a war. Whether

or not the President decides to authorize the use of force—and certainly he hopes that isn't required—it is vital that our country grow. It is vital that our country continue to create jobs for the millions of people who are looking for work and can't find work.

So we can afford a war and we will put it behind us, but we do need to make sure we have an economy that is growing and creating jobs for people who want work. That is what this plan is about, creating jobs for people who want work and growth for the economy so everybody can have prospects for a more abundant life.

Mr. RANGEL. You didn't say what this war would cost.

Mr. SNOW. We have a 10 point—toward $11 trillion economy.

Mr. RANGEL. How many wars can we afford? Mr. Rumsfeld said we can do two or three wars at the same time. Did he discuss that with you?

Mr. SNOW. My mission is with Treasury and not how many wars we can conduct at a certain time.

Mr. RANGEL. You said we could afford it. I heard Mr. Rumsfeld say this war may take 5 weeks, 4 months, or 4 years, and occupation may be $100 billion a year. They have thrown these numbers at us, and you are saying we can afford it and I want to feel that comfort. You must have some reason to believe that we can afford to stay there how many years.

Mr. SNOW. The reason I have comfort is the cost of the war will be small relative to the gross domestic product (GDP) of the United States.

Mr. RANGEL. How many wars are we talking about? How about North Korea?

Mr. SNOW. We are always trying to avoid a war.

Mr. RANGEL. We are always trying to avoid it, even though you don't get that impression from the television. Assuming that we are making every effort to avoid it, it looks like we may not be able to do it. So, you already said we can afford the sacrifices that we will make in Iraq, and I guess you have done a lot of study of that. I am asking whether there are any other wars that you figure we can afford to do economically, forgetting the lives of men and women involved.

Mr. SNOW. If you are asking me to foretell the next two, three, four, five wars, I am not in that business.

Mr. RANGEL. You are in the business of foretelling the budget and expenses of the government. I just thought that both of these were very, very important. Thank you, Mr. Chairman.

Chairman THOMAS. Thank the gentleman.

Mr. SNOW. I was going to say that this is a war to—if we have a war, the purpose of the engagement will be to eliminate enormous threat and risk to the American people. We can't put a price tag on that, Congressman.

Chairman THOMAS. Gentleman's time has expired. Gentleman from Illinois wish to inquire?

Mr. CRANE. Yes, Mr. Chairman. Secretary Snow, I would like to join my colleagues in thanking you for being here today. The last time you were here you did an extraordinary job of answering questions regarding the President's budget just 2 days after taking the office of Secretary of the Treasury. There have been several proposals offered by our colleagues on the other side of the aisle that

focus on a one-time increase in government spending and temporary tax cuts. Do such policies have any sustained long-term economic benefit?

Mr. SNOW. Congressman Crane, no, I do not think they have a long-term sustainable impact. One of the teachings, I think, of modern economics is if you are going to affect people's behavior today, you have to give them the sense that that tax reduction will return to them this year, next year, the year after, the year after that, rather than be a one-time shot. A one-time shot, frankly, isn't worth the money it costs to give them.

Mr. CRANE. In addition to the administrative and tax compliance benefits of increasing from $25,000 to $75,000, the annual amount of capital investment that small businesses can expense or immediately deduct each year, can you explain how the section 179 expensing provision will increase capital investment and create jobs?

Mr. SNOW. Yes. Small businesses—and there are some 23 million or 30 million, I forget the number now—there are an awful lot of small businesses, and they are the primary engine for job creation in America. The expensing means that those small businesses will immediately have a writeoff they don't have today. It will mean more money in their pockets. It will mean more free cash flow for the business. That heightened free cash flow will make the business more valuable. It will mean the business has a higher return on invested capital. It is the return on invested capital and that business goes up, that those small businesses become more profitable and they are more inclined to make additional expenditures and to hire additional people. So the expensing improves the economic outlook for small business, which means that small business will be more inclined to invest and hire.

Mr. CRANE. In addition to increasing the amount that a small business can expense, the proposal also increases the number of companies eligible for the provision. Can you tell us how many additional businesses will be eligible for the section 179 expensing under the proposal?

Mr. SNOW. I think that is roughly 23 million, 23 million firms who will be eligible for that and they will get the advantage of the lower marginal tax rates.

Mr. CRANE. Thank you. I yield back the balance of my time.

Chairman THOMAS. Thank the gentleman. Gentleman from California, Mr. Stark, wish to inquire?

Mr. STARK. Thank you, Mr. Chairman. Mr. Secretary, I am still puzzled over your assertion that the President is trying to avoid war, but we will come back to that as I try and think how in God's name he is doing anything to avoid war, but that is another issue.

We do have a crisis in consumer confidence, the lowest level in nearly a decade, because Americans are worried about low job market, falling stock prices, rising gas prices, the threat of terrorism and the President's insane commitment to go to war with Iraq at all costs. American families are prepared to send their sons and daughters, husbands and wives to war. In addition to buying duct tape and plastic, they are preparing themselves for what may be the ultimate sacrifice. Yet, this Administration continues to crusade for tax cuts for the wealthy. In other words, 60 percent of the

tax cuts you are talking about go to the 10 percent of the people in this country with incomes over $100,000. Fifty percent of the people in this country are going to get less than $256 in tax cuts. You are trying to tell us that is fair. If that is your assessment of fair, I suggest you got to go back and reread whatever book it is that told you about business ethics and fairness.

What I would like to know from you is, first of all, what you intend to do to pay for the war. When you were here a month ago, I asked you if anyone in the Administration talked to you about the cost of the war and you said no. I presume you have been on the job long enough to at least listen in on the discussions with Rumsfeld, Cheney, and Wolfowitz and have some idea as Secretary of the Treasury what the war is going to cost. You are going to have to come back to us with a debt limit increase.

When do you intend to do that and how much will you ask for? If you don't know, I think you are building up a good bill of impeachment for incompetence in your job. So let us talk about what you are in charge of and how you are going to pay for this crazy Administration's headlong rush into war and its overzealous commitment for cutting taxes for the rich and ignoring creating new jobs. I might add, it is the first Republican Administration out of the last two that has not extended jobless benefits beyond 13 weeks, which would really get the economy going if they would be willing to do that. Let us talk about the war, its costs, and what you are going to tell the American people about the fairness and how to pay for it.

Mr. SNOW. The tax cut plan, Congressman, as I indicated in my opening statement reduces the burden on the lower income——

Mr. STARK. Two hundred fifty-six dollars is for the median. That is it. That means half the people of this country get 256 bucks or less. Those are your figures, I might add.

Mr. SNOW. What it means, though, if this is passed, as I dearly hope it will be, the lower income people who are paying taxes will bear a smaller share of the total tax burden, and those are the numbers that I think are indisputable.

Mr. STARK. Hot dog. What about the million people who are on unemployment? What are you going to do for them?

Mr. SNOW. The best thing we can do for them is get the economy going.

Mr. STARK. You know what the President is going to do? He is going to put that money into one of these job training monkey business things and say go and get training, and these are all people who are working. You going to train plumbers to be chiropractors or are you going to get them jobs and pay their unemployment benefits so they can pay their rent and buy clothes for their kids and stimulate the economy as you suggest that is what you would like to do?

Mr. SNOW. I urge you to take a close look for that proposal and review the experience, Congressman, in the States where it has been applied because it has been a great success.

Mr. STARK. It hasn't been applied. It is a new pipe dream that this Administration has. So what you are saying is you are doing nothing. When are you coming back with the debt limit increase? When are you coming back with the debt limit increase?

Mr. SNOW. We have written a letter to the Congress indicating that the debt ceiling, which is currently $6.4 trillion, could be breached sometime in April or May and that we propose to have a dialogue with the Congress about the need to raise the ceiling. That, of course, has nothing to do with the war.

Mr. STARK. Oh, no, because you aren't including the cost of the war in your budget.

Mr. SNOW. Actually, it has nothing to do with the war. It is a result of the spending and taxing policies of the United States.

Mr. STARK. Good luck.

Chairman THOMAS. The gentleman's time has expired and the Chair thanks the gentleman for his questions. The gentlewoman from Connecticut wish to inquire?

Mrs. JOHNSON OF CONNECTICUT. Thank you, Mr. Chairman. Welcome, Secretary Snow. There is in my mind a lot of good reason for considering speeding up the changes to the individual side of the Code. This is a time when families desperately need every penny they can get. So, I think that could put money into the economy in a way that would be very strengthening to it. There has been a good deal of concern about the interaction between the dividends proposal and retirement security, the construction of affordable housing in our society, the ability of municipalities to borrow at zero interest. I wondered if you would comment on some of those reverberations of this proposal that do concern many of us.

Mr. SNOW. Yes, and I would be happy to. We are in dialogue with a number of people who represent those interests. Let us start out with the municipals. I don't think the proposal will have much effect on the munis at all, modest at best, because the investors in the municipals are really a separate and different—have different investment objectives than people who invest in equities. The municipals gives you some advantages that you don't get from equities. Equities have more risk to them, don't have an assured payment schedule, and don't have the stability. As I have looked at that one—and I tried to think about it—I don't think there will be much impact, modest at best.

Turning to the tax credits, again, I think the effect will be quite modest. The proposal, after all, is unlikely to lead to companies paying out all of their dividends, so they will still have an incentive of having some portion of their income sheltered from taxation. I am told—I am sure Secretary Clarida or Olson could confirm this—that the debt of corporations that are represented by tax credits, investment in tax credits, is very small, something like 1 percent or less than 1 percent for low-income housing, which is one of the areas that you mentioned in your comments to me.

We are also talking to another group involved with variable annuities. I think we can find a way to deal with the issue there. So I think with respect to the munis and with respect to the tax credits, impacts will be fairly modest. I know you are concerned about the low-income housing credits. I look forward to a discussion with you on that. On the municipals, the evidence I think there is really pretty clear, that we are talking about different investors with different investment profiles and different investment expectations. There will be—the diversion of funds will be in all likelihood from corporate debt—from bond to bonds into to—and other credit in-

struments of corporations into equities, not from the munis into equities.

Chairman THOMAS. Thank the gentlewoman. The gentleman from California, Mr. Matsui, wish to inquire?

Mr. MATSUI. Yes, I would. Thank you, Mr. Chairman. Mr. Secretary, let me throw out a few statistics as a background of my observation here. Economic growth in 2000 was 3.8 percent. Average for the last 2 years is 1.3 percent. The unified budget surplus, year 2000, was 238 billion in surpluses. We are now projecting $207 billion worth of deficits in this year and $204 billion worth of deficits in the next fiscal year that we are about to work on.

Unemployment rate was 4 percent in 2001. It is 5.7 percent today. The number of unemployed was 5.7 million in 2001. It is 8.3 million, a gain of 2.6 million unemployed today.

The value of the stocks in the equity market was $13 trillion and now it is about $8 trillion, a drop of about $5 trillion.

In terms of your dividend deduction proposal or the elimination of taxation on dividends, we had an MIT study recently analyze your proposal, and it says at the most, there will be a 5-percent increase in the equity markets from this proposal. With a drop of 35, 40 percent in the market over the last 2½ years, it seems kind of incredulous that we would rely upon a 5 percent increase.

Second, what is troubling from my perspective is that for this Administration that believes in the marketplace, it would seem to me you are using the Tax Code to try to temporarily jack up the market when we really should be dealing with fundamentals and obviously transparency in the market. So it just seems that approach doesn't make a lot of sense.

Second, I think both you and representative—Ms. Olson mentioned this—the benefit goes to the shareholder rather than the corporation; therefore, it has a very negligible effect in terms of changing corporate behavior in the sense of moving from debt financing for capital expansion to equity financing. In fact, it almost has no impact at all.

Thirdly, the—undoubtedly will increase the cost for tax-exempt bonds and that will have an appreciable impact on local and State government at a time when local and State government has an $80 billion debt in this coming fiscal year.

When infrastructure throughout the United States has to be really addressed, and I find—I have met with a group of State treasurers today and they just can't understand how this proposal can even see the light of day.

Lastly, I tend to disagree with you, but reasonable people hopefully can disagree, in view of the fact that in this fiscal year only $30 billion will be actually put out in the economy. I can't even imagine how this will have a short-term stimulus effect on the economy. You are telling us it is about $52 billion. I can't imagine what a stimulus effect it might have.

Thirdly, from a larger perspective, I want to follow up on what my two colleagues from California and New York have said. This total package, about $700 billion, and of course that doesn't include making the tax cuts of 2001 permanent, which would add about $600 million to it, but in terms of your priorities, in view of the fact that we are projecting deficits at least for the balance of this dec-

ade, would it not make more sense to either use the revenues that you are going to lose here on this tax cut to pay down the debt?

Or secondly, perhaps, maybe have a little insurance, just in case the war doesn't work out like everyone hopes it works out, that maybe it will go a year instead of 5 weeks, maybe instead of occupying our troops in Iraq for a year, if it goes 5 years, doesn't it make sense to have a little hedge and maybe we should wait for this tax cut for 2004?

Lastly, there is a lot of domestic needs out there. The President announced a prescription drug bill yesterday that is very sketchy and doesn't have a lot of details in it, but perhaps some of these loss of revenues that occur because of these tax cuts should be used for perhaps beefing up the prescription drug bill which we are going to have a very difficult time passing once this tax bill goes into effect and secondly, once the war goes into effect. I see deficits running $500 billion if in fact the war ends in rapid fashion and we are there for only a very limited period of time. It seems to me that we ought to use this money as a safety net instead of a tax cut that I haven't yet seen have an appreciable effect in helping the market or the economy.

Chairman THOMAS. Gentleman's time has expired, but obviously the Secretary can respond. Given the length of the questions, my assumptions is a number of these may be responded to in writing.

Mr. MATSUI. Whatever he wants to do is fine with me.

Mr. SNOW. This is an insurance policy. It is an insurance policy that we stay on the recovery and that those people who are looking for work can find work. That has to be a priority.

On the debt/equity ratios, I think it is going to be more powerful than your numbers suggest. We will give you the numbers on that. I don't think it is going to drive down the price of municipals, increase their yields very much at all.

The stimulus actually has a pretty powerful effect of 450,000 jobs, 500,000 jobs by the fourth quarter of this year. I will explain why that happens in the written response. I think investing in growth, which is what this package is all about, eliminating the biases in the Code to use debt rather than equity, and stimulating investment in equity capital will have a long-term powerful effect on corporate behaviors that will be very beneficial to the way the American economy performs, and I will elaborate on all that in my written answer.

Chairman THOMAS. Gentleman's time has expired. Gentleman from California, Mr. Herger, wish to inquire?

Mr. HERGER. Thank you very much, and thank you, Mr. Secretary, for being with us. I would like to comment on a question that was asked you just earlier by Mr. Crane on the Administration's support in your tax package. Knowing that over 90 percent of all businesses are small businesses, that over half of all new jobs are created by the small businesses, I want to thank you for your support for increasing from $25,000 to $75,000 the annual amount of capital investment that can be expensed or immediately deducted, as well as increasing that threshold from $200,000 to $325,000 of investment for a small business. This is legislation that I sponsored last year, again this year, that Senator Snowe has in

the Senate. Again, I thank you for having this in your plan, and as you have mentioned, see it very clearly as a major help to creating more jobs.

My question is that several of our liberal friends have commented that the Administration's tax proposals are simply a tax cut for the rich. Of course the child tax credit, the income tax bracket expansion for a 10 percent income tax bracket and the 15 percent tax income tax bracket and expansion of standard deductions for married taxpayers clearly benefit low-income people. However, there still remain the double taxation of dividends, which I strongly favor eliminating, still remain. Could you comment on how the elimination of this double taxation of dividends will benefit low-income taxpayers as well as retired taxpayers and will this proposal have an effect on increased wages?

Mr. SNOW. I thank you very much for that excellent, excellent question. Forty percent of the recipients—I should say it differently, 40 percent of all stock ownership in America—we have become an investing country with half of the families in America now owning equity. Forty percent of the equities are, in terms of number of people owning equities, are people with income of less than $50,000 a year. An awful lot of people who receive dividends are people with average incomes, modest incomes, moderate. People like my mother, the schoolteacher I talked to you about once, who depended on those dividends in her retirement. Found it enhanced her ability to enjoy life. With this proposal, can't be any doubt about the fact that many, many companies who are paying dividends today will pay larger dividends because the obstacle to paying dividends has been eliminated.

I can't tell you, Congressman, how many meetings I have been in as a chief executive officer (CEO) and a board member where the discussion turned to the subject, how do we reward shareholders? The first thing that came to mind was let us buy in shares because we can borrow the money and take a deduction to buying in shares. Of course, there was a lot of buying in of shares.

A second option that always was on the table was well, the market rewards us for being bigger. Why don't we do a transaction? We can borrow the money for the transaction and take a deduction.

The third option, dividends—should we pay more dividends—was always greeted with the response well, you know, if we do dividends, that it is so tax inefficient. It is taxed at the corporate, it is taxed at the individual level, and this has been said in every board room I venture in America; that is not a tax-efficient way to reward our shareholders. We have now taken that reason away. As we take it away, it is going to lead to enormous growth in the payment of dividends, putting a lot of money in people's pockets.

In addition, it is going to lead to a growth of equity capital. The growth of equity capital across America will lead to more investments. It will lead to a deepening of the capital stock. It will lead to business expansions. It will lead to higher productivity on the part of the workforce. It will make America better off and make America wealthier. If we make America wealthier, it helps everybody. A wealthier, more prosperous country helps everybody.

Chairman THOMAS. Thank the gentleman. Gentleman from Michigan, Mr. Levin, wish to inquire?

Mr. LEVIN. I think one of the problems you have is that a similar message as you are giving today was presented by some of your predecessors. So as they say, we have heard this song before. Let me give you one critique of that approach. I read it in quotes. In the example of fad economics that occurred in 1980 when a small group of economists advised Presidential candidate Ronald Reagan that an across-the-board cut in income tax rates would raise revenue.

"When politicians," this is a quote, "rely on the advice of charlatans and cranks, they rarely get the desirable results they anticipate."

You are now a politician and I am not suggesting that you have listened only to cranks and charlatans, but you know, after the 1980 tax cuts that weren't pinpointed, we went into these long trails of deficits, and we now have that after the most recent across-the-board cuts that weren't targeted. What is different this time? Why is that economist in his analysis wrong about this approach?

Mr. SNOW. Well, I don't know what the reference point for that economist's observation is.

Mr. LEVIN. To the experience in the '80s.

Mr. SNOW. I won't use this occasion to debate the merits of the 1980's tax cut. I will talk about this particular set of proposals. Congressman, this is good economics. These proposals are fundamentally good economics. Chairman Greenspan himself I think testified here just a week or two ago, and, when asked about the double taxation of dividends, said that it is good economics.

Mr. LEVIN. Didn't he say, though—let me just interject. What did he say about the deficits?

Mr. SNOW. What he said about the deficits is that in the long term deficits matter, but that deficits of the size we are talking about will not rile up or disturb financial markets.

Mr. LEVIN. You know, I think what you are doing is dismissing what he said—really, the gist of it. Also, what I read was from the first edition of the textbook by the person who has been designated as the leader of the Council of Economic Advisors, Professor Manchu. There is deep skepticism because what you say today was said a few years ago and was said 20 years ago. What we have seen from that approach is these deep, deep deficits and we better take them seriously.

I won't quote what you said some years ago, what you said about deficits. I think you also have changed your tune, as Professor Manchu and others have. I think what you said and what he said a few years ago is likely to prove historically correct about this one.

I want to talk about fairness for just a minute. You say in your testimony a typical family of four with two wage earners making a combined $39,000 will receive a total of $1,100 in tax relief. What percentage of the households is represented by that typical family of four?

Mr. SNOW. I think Ms. Olson has the answer to that.

Mr. LEVIN. What is the percentage? What percentage of the households?

Mr. SNOW. The percentage of households represented by the $39,000 with two children—I think—can I get that for you for the record?

Mr. LEVIN. I think it is about 25 to 30 percent.

Mr. SNOW. That could be.

Mr. LEVIN. So why do you use a figure that represents a small fraction? I will ask you this, too. The average tax cut for somebody earning over $200,000 would be $12,496. For over 50 percent, the tax cut would be $100. Assume you are in that category over $200,000, Mr. Secretary; what do I say to my constituents, so many of whom are in the half that would receive $100, that it is fair for them to get $100 and for you to get $12,496 and for someone earning over a million would get $90,000? What is the fairness in that?

Mr. SNOW. Congressman, you are talking from numbers that I have not seen before.

Mr. LEVIN. You have never seen these numbers?

Mr. SNOW. Not those numbers. I have seen a different set of numbers. Assuming I am talking about the numbers that I have seen, I think the answer is we all benefit from getting this economy going from creating jobs. The best thing we can do for people is create work and jobs. That is what this does.

I know that there is this notion of trickle-down economics that some people believe in. That is not what this is all about. This is about improving the total output of this economy. When we improve the total output of the economy, as Chairman Greenspan testified in connection with a question like this on the elimination of the double taxation of dividends, he said that virtually everyone benefits when we make the economy more efficient. That is what this does. It makes the economy more efficient.

Chairman THOMAS. Gentleman's time has expired. Gentleman from Louisiana wish to inquire?

Mr. MCCRERY. Yes, Mr. Chairman, thank you. In quick explanation of the reason why one might use the family of four as a typical example of the effect of the tax cut, by instituting the child tax credit, Congress recognized that the people in our society perhaps having the most difficult time making ends meet are those with children. We instituted a child tax credit to help those people to raise their kids, to give them a break in the Tax Code. So that, indeed, is a good example for us to use as to the true impact of the parts of this tax proposal.

Mr. Secretary, there has been a lot of talk about whether we can afford the tax cut and whether it is wise to do so. I think it might be instructive to look at the historical rates that income tax revenues have represented as a percent of our GDP to find out if we can afford it. Between 1945 and 2002, individual income tax revenues represented an average of less than 8.1 percent of GDP. Under the President's proposal, as I read the tables, individual income tax revenues with the tax cut proposed by the President in the years 2006, 2007, 2008 will be around 8.5 percent of GDP. So in other words, even after this tax cut, income—individual income taxes will represent a higher percentage of our national income than the historical average since World War II.

So I think the question we ought to be asking is how much are we spending and can we make our expenditures fit within that

over the long haul, with the exception, of course, for wars that we must fight, must win, and spend whatever is necessary to do that?

You mentioned, Mr. Secretary, in response to Ms. Johnson's question, annuities. I want to highlight that because I do think that may be an area of where the Administration in putting together its proposal overlooked an effect in the marketplace that would be unintended. Your proposal would tell individuals who purchase mutual funds that they can enjoy the tax-free treatment of dividends paid within those mutual funds. You said in your proposal that if that individual has a variable annuity, which is kind of like a mutual fund, except maybe better, if your object is to have that person save for the long term, save for retirement, he can't get that tax-free treatment of dividends paid inside that annuity. I know you mentioned it to Ms. Johnson. I would like for you to expand on that for just a moment so we can get that clear.

Mr. SNOW. The principle is income taxing once, and we are looking at the application of that principle to the variable annuity to see whether or not the principle is being properly applied. We are in technical discussions. Secretary Olson is looking at the matter and we are in discussions with the variable annuity industry, and I think we can find an accommodation there. It is not really a big issue, it is really a technical issue, and I think we can resolve it.

Mr. MCCRERY. I thank the Secretary for that response. I think it does deserve attention, and I am hopeful we can find a solution for that.

Several media reports noted that the bill as introduced by the Chairman of the Committee on Ways and Means, H.R. 2, has some differences from the Administration's initial offering, and one of those changes relates to the treatment of previously accrued alternative minimum tax (AMT) credits. Can you explain why the President's proposal has been changed, I take it with the Treasury's blessing, with respect to accrued AMT credits and why that is philosophically consistent with the rest of the package?

Mr. SNOW. It goes back to the issue on the variable annuities. We are trying to make sure we are consistent with this principle that dividends are paid only from moneys where a tax has previously been paid. The AMT is a tax, it has been paid, and should be credited. That is the basic answer.

Mr. MCCRERY. Thank you, Mr. Chairman.

Mr. SNOW. Very similar to the foreign tax credits.

Mr. MCCRERY. Yes, sir. In fact very similar. Thank you.

Chairman THOMAS. Thank the gentleman. The Chair wants to make sure that, based upon that discussion, that the Chair's representation of the legislation introduced as H.R. 2 is in fact an exact rendering of the President's proposal. Is that a correct statement?

Mr. SNOW. Yes, it is, Mr. Chairman.

Chairman THOMAS. I appreciate that. Does the gentleman from Washington wish to inquire? Mr. McDermott?

Mr. MCDERMOTT. Thank you, Mr. Chairman.

Welcome, Mr. Snow. I know you must—I hope you have taken a long-term lease on your house because I think of Mr. Lindsey and Mr. O'Neill and Mr. Hubbard, and I feel like you are out here rearranging the chairs on the deck of the Titanic. I read the local news-

papers, and they tell me we are going to war. Now, I am not going to ask the question of the Committee or the audience how many think we will be at war in 30 days, but I bet you I would have an overwhelming number of people think that, which is why the consumer spending has dropped and it is going to keep dropping. Mr. Ridge says we are certainly going to war, and Mr. Bush talks about he is going to do a war to bring a lasting peace, and he points to the statue of Theodore Roosevelt. So, you know, he is the guy we are looking back to.

So I started thinking about that, and I thought, well, every time we have had a war we have had a tax increase. Are you getting your answer ready, or are you listening to me? I was just wondering. We are not sure just exactly how big this war, how much it is going to cost, because the guys who said it cost a hundred billion they got dropped out the window and so we don't know what it is really is.

In 1796, the Committee on Ways and Means reported to the Congress a bill to adopt a death tax to develop a strong naval force because of the problems with France. In 1862, Mr. Salmon Chase, your predecessor, and President Abraham Lincoln enacted the first income tax to raise revenue for the war for the Union. Then again in 1898 President McKinley reenacted the War Revenue Act to pay for the Spanish American War, and America sent its young men to war in Europe. At the suggestion of Mr. Roosevelt, Mr. Wilson put on the death tax again. Then World War II, we raised all kinds of taxes. We did it in the Korean War, we restored the excess profit tax. Every single war, we have raised taxes. Now you are sitting out here and saying 300 years—3,000 years of public finance, we are going to go to war, and we can cut taxes and don't worry, folks.

How in the world can you sit there with a straight face and sell that to the American people when the history is as I said it? Now, maybe you quibble with my history. If you don't, then I would like to hear how you are going to be the first Secretary of Treasury in the history of the United States who cuts taxes during a war and pays for the war. I don't know where you are getting the money from, because nobody is spending. You can give $250 to the average truck driver or cab driver or schoolteacher and a lot of people. If you think that is going to bring up the economy, no, no, they are paying down their credit card debts. They are putting a little extra on their house payment. They are doing a lot of things to save it. They are not going out and buying stuff. That is why we are not having a recovery. As long as you have this war, everybody says you are not going to have recovery.

So how are you going to sell this to the American people? We are going to cut taxes. I guess it is because you have given up on deficits. I guess deficits don't mean anything.

Mr. SNOW. No. Deficits matter.

Mr. MCDERMOTT. Oh, they do?

Mr. SNOW. As I testified before you last time——

Mr. MCDERMOTT. The first rule is when you are in a hole, stop digging.

Mr. SNOW. Congressman, the hole we are in now is we are not creating jobs. The hole we are in right now is we are not growing the economy. The hole we are in is we are diminishing the pros-

pects and the outlooks for millions of Americans. That is a hole we have to get out of. You are a much better student of history than I am, but that recounting of all those tax increases in the time of war, you know, the President wants to avoid a war here. That is——

Mr. MCDERMOTT. Is there anybody in this room who believes we are not going to be at war? Wait a minute. I know he wants to avoid a war. Of course you do. Is there anybody in this room who believes we are not going to war? Anybody? You see?

Mr. SNOW. Well, I don't think people want to intrude on your questioning here of me.

Mr. MCDERMOTT. Surely there is somebody here who wants to defend the President's not going to war. Surely there must be somebody who thinks he is going to keep us out of war.

Mr. SNOW. I think it is pretty clear the President——

Mr. COLLINS. Would the gentleman yield?

Mr. MCDERMOTT. Where?

Mr. COLLINS. Right here. Collins is the name.

Mr. MCDERMOTT. Collins. Yes, sir. Do you think we are not going to war?

Mr. COLLINS. There would be a lot less chance we would go to war if we didn't have so many naysayers in the group. Depending on the President and strategy of building the defense and showing the strength of the United States and stop undermining with all your rhetoric.

Mr. MCDERMOTT. Oh, so now it is us.

Mr. MCCRERY [Presiding.] The gentleman's time has expired The Committee will be in order.

Mr. COLLINS. The answer is up to Saddam Hussein.

Mr. MCCRERY. The Committee will be in order.

Mr. Johnson from Texas may inquire.

Mr. JOHNSON OF TEXAS. Thank you, Mr. Chairman.

You know, you keep getting asked about the cost of war. I hear so many misstatements of fact I can't believe it. It seems to me that for 40 years under Democrat control in this Congress the debt limit kept going up and money kept being spent. I didn't know anyone except in the past Administration that believed in double taxation for anybody. I think you are right on target when you say the President is thinking about taxing money once and once only. That is the theme throughout this thing. You guys need to realize that.

I know it seems like the several proposals offered by the Democrats focus on a one-time increase in government spending. Do such policies have any sustained long-term economic benefit as far as you can see?

Mr. SNOW. Congressman, no. I think the virtue of this proposal is that makes a long-term real improvement in lowering marginal tax rates so people can count on having those lower marginal tax rates into the future. The evidence indicates that one-time spending proposals do almost nothing to improve employment or assist the economy in achieving higher levels of growth. Almost nothing.

Mr. JOHNSON OF TEXAS. How can a Democrat plan to spend more money not cause us to exceed the debt limit either? Isn't that something that would happen if we spent more money?

Mr. SNOW. I think when you look at these numbers that the Chair raised with me earlier, it is pretty obvious that we get into trouble on the deficit because of the spending side, and the spending side historically has been what leads to significant trouble on the deficit side. Revenues tend to stay in that 17, 18, 19 percent range. Spending though has much greater variation or amplitude. It is, the spending has to be watched here very significantly. We really don't have a serious deficit problem as long as we watch spending. There are plenty of revenues coming in. These revenues are going to be rising, as the Chair pointed out in his questions to me. So I am in complete agreement with the tenor of your question.

Mr. JOHNSON OF TEXAS. Thank you. I would like to ask you, then, what will be benefit be of accelerating the marginal tax rates now? That is a tax reduction.

Mr. SNOW. That is a very significant tax reduction. Again, one of the teachings of economics I think is you get less of everything you tax and more of everything you reduce taxes on. Marginal tax rates, high marginal tax rates reduce the incentives to work and reduce the—therefore, reduce the output of the economy. By lowering marginal tax rates on individuals will encourage individuals to work harder and will put more disposable income in their hands. As they have more disposable income in their hands, they will spend it. They will do something with it. That will benefit the economy. In particular here, the lower marginal tax rates for small business means those businesses become more profitable. As businesses become more profitable, they invest, they expand, and they grow. This is a vehicle for small business to expand and grow and hire.

Mr. JOHNSON OF TEXAS. Exactly, and create more jobs in the process. Well, let me just say I didn't see a cushion, as was talked about before, during the Vietnam War, and maybe that is to my detriment. I know that I have talked to our military, and they are energized, they are ready, and we do have the dollars to support them if we have to. I thank you for your comments, sir.

Mr. SNOW. Thank you, Congressman.

Mr. MCCRERY. Mr. Lewis.

Mr. LEWIS OF GEORGIA. Thank you very much, Mr. Chairman.

Welcome, Mr. Secretary. Mr. Secretary, you know better than any of us this Administration is halfway home. You are in the third year and time is running out. Time is late. I want you to tell us, what went wrong? How did you and the Administration get on this road? In order to know where you are going, you must know where you have been and where you are. This Administration came into office with a surplus. The surplus is gone. What happened? In the previous Administration, more than 22 million jobs were created. During the first 2 years of this Administration, we have lost more than 8 million jobs. You talk about jobs, creating jobs. Why now in the third year of this Administration? What happened during the past 2 years?

Mr. Secretary, the economy is in a ditch, and the ditch is getting much deeper. Do you really believe that your proposal and the proposal of the Administration would get the economy moving? Would you like to respond?

Mr. SNOW. Yes, Congressman. I can respond enthusiastically in the affirmative to that question. Absolutely. There can't be any doubt about the fact—and I mean this from the bottom of my heart. I mean this with the deepest sincerity. There can't not be any doubt about the fact that this proposal will create hundreds of thousands of jobs for Americans looking for work; that the estimate of the economists in the Administration—Mr. Clarida is one of them—is that by the fourth quarter of this year, if this is enacted by mid-term, by June or so, that there will be 500,000 additional jobs; that by the fourth quarter of next year there will be a million and a half additional jobs; and by 2005, well over 2 million additional jobs. Growth rates of an additional 1 percent in GDP for this year and another 1 percent for next year. So a total of 2 percent additional GDP. That is a tremendous improvement in the outlook for the American economy, and I have no doubt that that would be the effect of lowering rates as proposed.

On this issue of the surplus and squandering the surplus as the charge goes, you know, this Administration inherited a recession. This——

Mr. LEWIS OF GEORGIA. You had a surplus. You cannot deny the fact that there was a surplus. What happened to it?

Mr. SNOW. Well, it was a surplus on paper. It ought to make everybody who does economic forecasts very humble. It was never there in reality. It was a number on a piece of paper that was wildly exaggerated. That is what it was.

Mr. LEWIS OF GEORGIA. Mr. Secretary, let us turn to another question that some of my colleagues on this side of the aisle have raised. As one Member, just one Member of this Committee, I must tell you that I am deeply troubled with our rush to war. During the past 40 years, I never seen anything—anything—nothing that troubled me more than our rush to war. Are we prepared to rob our people, our senior citizens' quality health care, are we prepared to steal from our children to finance a war? Some people are saying that the war will cost $60 billion, $95 billion, maybe $100 billion. Can you tell us how much this war is going to cost?

Mr. SNOW. Well, first of all, as I have said earlier, the President's objective here is to bring peace to that part of the world and end terrorist and——

Mr. LEWIS OF GEORGIA. Do you bring peace by destroying the Nation and destroying people, destroying our own people and destroying other people? Do you call that peace?

Mr. SNOW. Well, Saddam Hussein has the option of complying with the U.N. resolution. The President is giving him that option. He is urging him to respond to the U.N., to the rule of law, and it is his option. It is his option, and he seems to be rejecting that option. So the President isn't seeking war. The President is seeking an end to a tyrannical regime that tortures its own people and accumulates weapons of mass destruction. That is going to make the world a more peaceful place, not a more warlike place.

Mr. LEWIS OF GEORGIA. Mr. Secretary, I wish you could tell us and tell this poor Member, I don't understand how we are going to do all of these things. Health care for our senior citizens, prescription medicine, no child will be left behind, we are going to finance education, clean up the environment, and then fight a war

and spend billions of dollars. Where are we going to get the resources from?

Mr. SNOW. We have the most——

Mr. LEWIS OF GEORGIA. Have a tax cut?

Mr. SNOW. Well, the tax cut is going to help us get where we need to get. The tax cut will help us create the robust economy that makes paying for those things possible.

I think it is important to keep in mind that over the next 10 years GDP is projected to grow by $142 trillion. The revenue impact of this proposal is only 1 percent of the growth in GDP over that time. We can afford that. We can only afford it if we have the economy growing and performing the way it can grow and perform.

Mr. MCCRERY. The gentleman's time has expired. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman. I feel like the other side has got their theme down. It is just they are attending the wrong hearing today. So I would like to get back to the economy, if we could do that, Mr. Secretary. Thank you for coming to be before us today.

Mr. Secretary, like most of my colleagues, I agree with the underlying economic argument behind the President's tax plan regarding the double taxation of dividends. Taxing the same income twice, as you have said, is inefficient and unfair. Yet the other side says that this is just another handout to the wealthy. As you have mentioned, Alan Greenspan's testimony when he was here on the Hill recently, he says about the double elimination—double taxation of dividends, he says the elimination of the double taxation of dividends will be a benefit to virtually everyone in the economy over the long run, and that is one of the reasons I strongly support it. That is a quote from Alan Greenspan.

I wonder if you could explain to us how the dividend proposal is in fact a tax reform that will benefit all citizens whether or not they own stock that pays dividends.

Mr. SNOW. Thank you very much, Congresswoman, for that good question, and I must say I was delighted to see the Chairman's testimony in which he pointed out the benefits of the elimination of double taxation. Eliminating double taxation of dividends will benefit the American economy in a number of important ways. One, its immediate impact—and I hate to talk economics here, but its immediate impact is to increase the return on equity capital. As we increase—by taking that tax away, the return on equity capital will rise. As the returns on equity capital rise, we will find lots of investments of equity capital, and we will see money coming out of debt instruments, corporate debt instruments into equity instruments. The total size of the capital pool of the United States will rise. As the total pool of capital in the United States rises, that means that every worker will have on average more capital to work with. As workers—as the capital per worker rises, productivity goes up. As productivity goes up, it raises real wage rates. That is what leads to a more abundant life for millions and millions of Americans.

The proposal also will have some beneficial effects on the stock market. Earlier there was some comment that it will be punier, minuscule. I think it is going to be more than that. I think we can see—I have seen estimates that the increases in the stock market

valuation could be as high as 15, 20 percent. That is pretty sizable. When you are talking about a market worth $8 or $9 trillion and you increase it 10 or 20 percent, you are talking about huge amounts of money that becomes wealth in somebody's hands. In this investor society where people are checking their 401(k)s and their individual retirement accounts (IRAs) and their ROTHs and so on, their pension plans, to see the net worth of their retirement accounts go up gives them a greater sense of confidence, makes them more willing to spend.

There is a huge beneficial impact of this proposal on corporate behaviors. We live in a day and age when there has been a lot of questions raised about behavior in the boardroom and what can be trusted and what can be believed and what is the real earning power of companies when there have been so many questions raised about accounting. One thing we know, you can't kid around about cash. As companies pay out more dividends, and they certainly will, the confidence in corporate America, the confidence in the earning power of these enterprises will increase enormously, and that will be helpful to our capital markets.

So I think for any number of reasons here, a variety of reasons, ending the double taxation of dividends, putting debt and equity on the same level playing field will remove an important rigidity in our economic system. It is interesting to look at the numbers. The United States today taxes capital at the very highest rate except for one country, Japan, of all the developed Nations. As I said earlier, we tax things we don't want. Why would we want to tax something that is the very life blood of our economy, capital?

Ms. DUNN. Thank you, and I like that educated answer. It is a relief to hear from somebody who has been inside those boardrooms instead of ivory towers. I think often our comment comes from the wrong source.

Let me ask you a quick question here since I am running out of time.

Mr. MCCRERY. The gentlelady's time has expired. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. Secretary Snow, once again, it is a pleasure to have you before our Committee. When you have large deficits and you want to propose a policy that is likely to add to the deficits, it seems to me you have to have an urgent public need for that type of policy to be acted upon. Clearly we have a need for homeland security and we need to do everything we can on homeland security and we have to move forward on that. We have an urgent need with our seniors on prescription medicines, and I think on both sides of the aisle we acknowledge the fact that we are going to have to do something in those two areas; and that the deficit is very important for us to deal with, but we need to make sure that we have homeland security and prescription medicines.

As I understand the issue at today's hearings, we are talking about the Administration's stimulus proposal, which is being proposed to stimulate the economy, and I have listened to a lot of the debate here. I want to share with you the thoughts that have come to me through respected economists. That is, they said if you want to stimulate the economy, if you think the Federal Government can help in that direction, the most important thing is to get money

into the hands of people immediately, because that may affect their behavior in spending more money. The major proposal you have, and you have been talking about it, is the dividend exclusion. I guess my question to you is, do you have any statistics as to how much of the total tax relief will get into the hands of our taxpayers in 2003 under that proposal?

Mr. SNOW. Congressman, I don't have that readily available. I would—I will get that and make that available. As I recall, something like half of the total job creation over the next 5 years is from the dividend proposal. In the short term more of the impact is from accelerating the rate reductions and the child credits, and so on, from the outyears and bringing them in. Now, the dollar value of that in the given period is we have it at the calendar year 2003 in at over $100 billion.

Mr. CARDIN. One hundred billion dollars from the dividend exclusion?

Mr. SNOW. No, no. For the total package, of which the dividend exclusion is about $20 billion to $25 billion.

Mr. CARDIN. Twenty to $25 billion in 2003?

Mr. SNOW. In 2003.

Mr. CARDIN. Do you know what the 5-year or 10-year projections are on the dividend exclusion?

Mr. SNOW. The cost to the government?

Mr. CARDIN. Correct.

Mr. SNOW. The cost is $390 over 10, and that is without any feedback, so——

Mr. CARDIN. I understand that.

Mr. SNOW. So over 5—I don't have the 5-year number, but I think it is like—$153.

Mr. CARDIN. Well, let me just do some quick arithmetic here and this is what concerns many of us. We are placing a $390 billion loss of revenue against a projected deficits, which will add $390 billion to the projected deficits. I understand your argument on economic impact, but we are going to be looking at a $390 billion additional hole to dig ourselves out of, and only $20 or $25 billion of that, or less than 10 percent—well, less than 10 percent is effective in the year that we are trying to get activity from the consuming public in order to stimulate the economy.

So I would just urge that as we look for ways to stimulate the economy we should at least listen to the good advice of the economists that say that if you are going to stimulate the economy look at something that will affect the bottom line of consumers in 2003 and is fiscally responsible over its lifetime. That is why temporary relief seems to be the preferred course.

Mr. SNOW. Just a couple comments. The President's proposal, while having small—relative to the total size of the package, small dollar direct impacts in the early year, in 2003, of course will have major economic impacts, because as taxpayers realize that the tax reductions, the tax relief, the $1,000, $2,000, $3,000, whatever it is they are going to receive, isn't just for this year but is for the next year and the year after and the year after. It begins to have a powerful impact on their current behaviors, I think, Congressman, an impact which is much more powerful, most economists would agree, than just giving them money in a given period.

Mr. CARDIN. Mr. Snow, I just point out that we are going to be faced though with a budget weighing on us of $390 billion we are going to have to make up, which is going to affect the other programs I have referred to. Thank you, Mr. Chairman.

Mr. MCCRERY. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Secretary, it is a pleasure to sit here and listen to you, as evident by the fact of your comments and how focused you are on this particular package, this growth package, that you have created jobs. That is a plus. It is much better than listening to some of those who just talk about creating jobs. You know the reality and how it is done.

Would you not agree that the American workforce is involved in a global marketplace, not just a domestic?

Mr. SNOW. Absolutely.

Mr. COLLINS. Well, you mentioned a minute ago that only Japan taxes a certain portion of our economy less than we do; we are higher than any other. If we are global marketplace and competing with other Nations, as our workforce competes with their workforce, does it not make sense to look at their tax provisions and try to beat them or meet them?

Mr. SNOW. I think in many ways the American economy is much stronger, more resilient, and the fundamentals are better. In this way, this particular way, this integration between corporate and individual taxes, I think some of the other countries have got it better than we do, frankly.

Mr. COLLINS. Well, they do, and that is the reason you are having the inversion problem that we are having, that is the reason you are having companies that are moving offshore, taking the jobs with them. That is the reason you are having some foreign investors come in and purchase and then move, because the competition is less by being located in another Nation rather than here. Who loses in a situation like that? Is it not our American workforce?

Mr. SNOW. There is no doubt about the fact that corporations make decisions based on the Tax Code.

Mr. COLLINS. They do.

Mr. SNOW. They flee high taxes.

Mr. COLLINS. So you agree then, it is the workforce that actually loses out when a company moves offshore to better their bottom-line position?

Mr. SNOW. Without any doubt. I mean, the fact of the matter is corporations collect taxes. They don't really pay them. They do take actions in response to the tax rates.

Mr. COLLINS. Well, now you are getting to the bottom line. You are getting to the bottom line, and that is exactly right. We are talking about, I believe you said, something like 23 million businesses would be affected by this tax bill either through expensing or dividends or some structure?

Mr. SNOW. That is right.

Mr. COLLINS. The purpose of this, the idea of it is to create jobs through a strong economy. If only 10 percent, one out of 10 of these 23 million create a job, how many jobs is that? 10 percent, how many jobs is that?

Mr. SNOW. You made your point. You made your point. It is a big number.

Mr. COLLINS. Yes, sir, it is.

Mr. SNOW. I told you earlier, the Committee earlier that we foresee over 2 million additional jobs in 2005. A good number of those will come from small business, I am convinced.

Mr. COLLINS. Well, the benefit of the focusing on the capital, as you said, is that it will change the pattern of businesses as far as investing or purchasing. As the President said in Cobb County, Georgia a couple of weeks ago, when you have this type incentive in place, when small business makes a purchase that they can expense out that year, someone has to make that product that they are purchasing. Is that not true?

Mr. SNOW. That is the way the economy works, absolutely.

Mr. COLLINS. That is how the economy works. That is how you create jobs. You don't sit around up here on this dais and talk about creating them, you do it by doing it in the marketplace, in the economies. You try to compete in the world market, not only competing with workers in other countries where products are made similar than ours in exporting, but competing with the imports from those countries who are sold here domestically. Is that not true?

Mr. SNOW. That is absolutely true.

Mr. COLLINS. Well, I appreciate the fact that the President is focused on a package that is a growth package. It is a package that I feel like that is more in relation to building a long-term relationship with the workforce in this country rather than looking at some kind of so-called stimulus plan that would only create a one-night stand for those who are depending upon the government to take care of them from the womb to the tomb.

So I appreciate the President for what he is doing and how he is focused and how he is actually working toward creating jobs and looking after the workforce in this country. Thank you, Mr. Secretary.

Mr. SNOW. Congressman, thank you very much.

Mr. MCCRERY. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman, and, Mr. Secretary, we appreciate your being here today to give us some perspective on this proposal. I think the package has a remarkable balance and I think up and until your testimony today, perhaps the Administration has undersold its benefits in the short term. What I love about the package is it deals with our two biggest issues. One is keeping consumer demand up, and Mr. Stark earlier talked about the fact that consumer confidence today we find is at a 10-year low. Auto sales are down in Mr. Levin's State and my State. That is a big deal. We have a problem right now on the consumer front. The consumers have kept us in the game, haven't they, for the last couple years, and now consumer demand seems to be shaky?

Mr. SNOW. That is right.

Mr. PORTMAN. Can you tell us a little bit about how the proposal on eliminating the double taxation on dividends will help with regard to consumer demand, particularly with what you said earlier about boosting stock prices?

Mr. SNOW. I think there will be a direct byplay between the dividend proposal and consumers. First of all, half the American families now are investors in the stock market, and this will lead to more disposable income in millions and millions of families. That is, the elimination of the double taxation of dividends will lead to millions and millions of families having additional disposable income. It is also going to lead corporations to pay a lot more dividends. I think there is just no doubt about the fact that once we end this tax inefficiency, this high cost for corporations to reward their shareholders with dividends—and that is how it is perceived by corporations, as a very burdensome way to reward your shareholder—we are going to find corporations paying a lot more dividends.

The stock market has to be benefited. Just take a simple example. Suppose there is an equity of $50, pays a 3 percent dividend, $1.50, the dividend gets taxed at 30 percent. So that is only a dollar in the hands of the ultimate shareholder from the $1.50 the company wants to pay. Let us assume that the company has 200 million shares. 50 cents times 200 million shares, there is $100 million of additional after-tax earning power that the NBC corporation now has. The marketplace will look at that $100 million of additional earning power and say that company is worth more. Any organization that can—any company that can demonstrate to the marketplace that it is earning, producing more after-tax dollars will be a more valuable place for investors to invest. They will want to invest in that. That will drive the price up. It will drive it up by some factor, depending on the discount rate of the investors. Equities sell, as you know, Congressman, in the mid range, 15 to 20 times earnings, six to eight times free cash flow. Well, the math is pretty clear. We are going to create a lot of additional wealth in the hands of shareholders. That is going to make people feel better.

One of the reasons I think confidence is down is markets are down. In this investor society with markets being down investors don't feel as good about their future, don't feel good about the present. That makes them more reluctant to spend, makes them more reluctant to invest, more reluctant to buy that new car, take that vacation, get the refrigerator and all the things that really in the aggregate create the economy we know as the American economy.

Mr. PORTMAN. I think that is a very good point, and you talked earlier about the wealth effect. Economists don't agree on much, but they agree there is a wealth effect. With the market going down, the wealth effect has been negative. With it going up, you are going to see people getting out there and purchasing more cars and more appliances, and that is a tremendous benefit to this plan.

The second weakness we have obviously is on the business investment side, and that is something that has been lagging over the last few years and continues to lag. Now obviously not taxing dividends twice and corporate earnings twice is going to help with business investment.

Can you expand on that a little more and talk about how that second component of our economy will be strengthened?

Mr. SNOW. Yes. We talked earlier about the fact that the consumer has been carrying the American economy, and the housing market, low interest rates in the housing market. What we have lacked is the corporate sector making investments. By improving the returns that they will get for making investments, we are going to encourage investments. We are going to encourage more investments on the part of corporations using equity, That has to be positive for the economy.

Mr. PORTMAN. That is the investment in plant equipment that is going to give people jobs; that is the expansion——

Mr. SNOW. Exactly.

Mr. PORTMAN. That we need in order to get people back to work?

Mr. SNOW. That is exactly right.

Mr. PORTMAN. Final question.

Mr. SNOW. We lower the cost of doing that, we lower the cost of business expansion by eliminating the double tax.

Mr. PORTMAN. There has got to be a pent-up demand on that. Just a quick comment on the possibility of war in Iraq and terrorism. We need an insurance policy, too. Those who are concerned about that must realize that not only do we need to increase consumer demand and increase business investment, we need an insurance policy. This is an uncertain world. The final question I have for you on the dividend side, we have looked a lot at the issue of offshore——

Mr. MCCRERY. The gentleman's time has expired.

Mr. PORTMAN. Thank you.

Mr. MCCRERY. Mr. Tanner.

Mr. TANNER. Thank you, Mr. Chairman. Thank you, Mr. Secretary. I have enjoyed your testimony. I agree and I am very interested in your proposal with regard to corporate governance. I have always thought a tax policy that advantaged debt over equity is wrong-headed, and you spoke to that. I agree, too, that spending is one of the central items that we ought to look at with regard to deficits. I think you would agree that spending, domestic discretionary spending as a percentage of GDP since 1993, the last 10 years or so, has been relatively flat as a percentage of GDP, domestic discretionary spending. I hope you can agree with that.

Mr. SNOW. Yeah. I think it has risen here in the last few years fairly markedly. Over the period of the late '90s, 1995 to 1999 or something, I think that is right.

Mr. TANNER. Pretty flat. Here is what I would like to ask. Presently, we are at $6.4 trillion in national debt. Eight months ago the Congress raised the debt ceiling $450 billion. You testified that, well, that is about, in my calculation about 7 percent of our total national debt over 225 years, $450 billion. We are going to reach that in the next month or two. We are looking at a $300 billion deficit this year or thereabouts, 200-plus, in the $300 billion range. We are looking at interest payments both accrued to the trust funds and checks we wrote of over $320 billion last year. If you put that to the pencil on a $1.83 trillion income, we have a 17 percent interest rate basically on the country. The Blue Dogs, which I belong to, call this a debt tax. In other words, the more we borrow,

the more interest we have to pay. Right now our credit cards are carrying a 17 percent rate.

So my question is, at what point does the central debt become unmanageable as it rises from $6.4—another $450 would be $6.8 as you go on up. If we hit $450 every 8 months over the next few years, one can readily see this central government debt becoming almost $10 trillion pretty quick. At what point does that become either unmanageable or a severe problem for the country, and at what point does this carrying charge, this interest rate on present income become something that will not allow the government to make the necessary public investments so that private enterprise can expand? Thank you very much.

Mr. SNOW. Congressman Tanner, those are excellent questions. Let me try and respond.

The debt level becomes a problem when it is so large relative to the GDP that it begins to crowd out private debt, private capital. We are not close to that point in the budget that has been proposed in any of the years that are in that 10-year outlook. I do agree with you that it is very important to always keep that thought foremost in our mind. Are we crowding out private capital? Is the debt too large to be sustained? What is happening to the interest payments on the debt? Now, of course, we are fortunate today that interest payments on the debt, even though the debt has gone up, the total interest payments have been coming down. It is one of the categories of the Federal budget that is in decline.

Mr. TANNER. About as good as it is going to get, I am afraid.

Mr. SNOW. Well, we are fortunate to have these low interest rates. Interest rates will undoubtedly rise some over time as we get back closer to full employment over the course of the next few years, but I don't see anything that suggests we are going to create an unmanageable situation at all. In fact, the debt levels—I don't have the numbers directly in front of me, but the level of total debt to GDP will begin to recede here and will stay within moderate historic—by historic standards, moderate levels. The deficits will—which will be around 3 percent this year and next—will come down to the 1.8, 1.7 in 3 or 4 years out.

Mr. TANNER. Could you address the carrying charge, the interest rates?

Mr. SNOW. The carrying charge——

Mr. TANNER. We are paying about 17 percent of our income on interest now. What concerns me, Mr. Secretary, about that——

Chairman THOMAS [Presiding.] The gentleman's time has expired. If you could conclude. You can conclude.

Mr. TANNER. Could you address that? At what point? Is it 20, 25? At what point do you see the government being severely hampered from making the necessary public investment for private enterprise to flourish and expand, which is where jobs are created in the private sector, but there has to be all of the necessary public investments made?

Mr. SNOW. I agree, there is a point. I don't think we are close to it. I don't think we will see it under any of the budget scenarios that have been laid out here. Clearly there is a point, and we always want to have a large margin to be within that point.

Chairman THOMAS. The gentleman's time has expired.

Mr. TANNER. If you could find out, I would like to know.

Chairman THOMAS. The gentleman's time has expired. The gentleman from Illinois, Mr. Weller, wish to inquire?

Mr. WELLER. Thank you, Mr. Chairman. Mr. Chairman, and Mr. Secretary, I join my colleagues here on the Committee in welcoming you back before our Committee, and appreciate the time you are giving us today and the opportunity to talk about the President's economic growth package that he has before us.

The last few weeks I have had the opportunity to travel throughout my district in the south suburbs and part of northern Illinois talking with workers and small business people and taxpayers alike, and they like much of what is in the President's plan. They agree we need to put extra spending in the pocketbooks of consumers, they agree we need greater incentives for business to invest in the creation of jobs. They like the fact that the President's proposal has immediate tax relief, which will immediately put extra money in the pocketbooks of Illinois taxpayers. I would note from the information I have under the President's proposal that the average Illinois taxpayer in the south suburbs that I represent would see about an extra $1,000—$1,068 in higher take-home pay, which would be immediately available because of adjusting and the withholding on taxes as a result of the rate reductions, and also the fact that we make immediately effective the elimination of the marriage tax penalty, which will benefit 46 million couples who pay on average $1,700 just because they are married. Also, for those who have children, 34 million families with children would benefit from the immediate increase from $600 to $1,000 of the child tax credit. I would note under the President's proposal a check would be sent out shortly after it became law, again putting money immediately into the economy. So they like those ideas.

I would like to focus on the business investment portion of the President's proposal. The economy in my area, of course we have a lot of petrochemicals, we have heavy manufacturing, but we also have a lot of smaller manufacturers. Those that are family-owned are usually the primary employer in many of the communities and the suburban communities as well as rural communities that I represent. They are owned by the families who live right in town. They usually employ a few hundred people. So they don't necessarily qualify as a small business, but they are small manufacturers. I was wondering, I am a strong believer in expensing and of course what the President has proposed, increasing small business expensing from $25,000 to $75,000. I believe it will encourage an increase in purchases of delivery vans and pickup trucks and company cars and telecommunications equipment and office computers.

I was wondering, could you just share with us the reasoning why it is important to increase that small business expensing from $25,000 to $75,000?

Mr. SNOW. Yes, Congressman. The primary reason is that small business creates far more jobs than anybody else. It is the engine of job creation, and an awful lot of small businesses today are hurting. You mentioned the ones in your district. I have been traveling the country and having townhall meetings, and virtually everywhere I go small business people are expressing concerns about the

economy. They are expressing concerns about their insurance rates, their health care costs, a whole range of things, and they are in a frame of mind that has them not optimistic, not confident, and not making investments.

The expensing proposal makes their businesses—produces more free cash flow for their businesses. It makes their businesses immediately more profitable. Coupled with the lowering of the marginal tax rates which would be 11, 12, 15, 17, 20 percent, depending on what category they are in, it means these businesses become instantly much more profitable. As businesses get more profitable, there is an incentive to invest. You want to grow and expand a more profitable business, and these actions will make those businesses more profitable. In addition, these actions will make those businesses more viable and better credit risks. They will make the businesses worth more, so the businesses will be in a better position to secure credit. That is one of their concerns today.

Mr. WELLER. Mr. Secretary, in building on the arguments for the small business expensing, which I strongly support, many of those small manufacturers in the south suburbs and rural communities that I represent, they do not qualify as a small business. They employ a few hundred people and they don't meet the definition. The question would be, in the thinking of the Administration, putting together the economic plan, could you explain why the Administration did not go further on accelerated appreciation or full expensing for other businesses?

Mr. SNOW. Yeah. I think when the paper was put to the pencil, it was felt that we got the most bang for the buck by an expensing proposal targeted on the small businesses that are eligible for this proposal as opposed to investment tax credits or other expensing or accelerated depreciation generally for business. That was simply sort of an internal economic calculation of the costs versus the benefits and where do you get the most bang for the buck.

Mr. WELLER. Thank you, Mr. Chairman. I see my time has expired. Thank you, Mr. Secretary.

Chairman THOMAS. Brief follow-up by the Chair on that. I understand you looking for bang for the buck. Would you say that at least in a narrow range, if you decided to go from $25- to $75,000 on the expensing or to go from $75,000 to $100,000 on the expensing, that those dollars are relatively more attractive on a linear basis? That is, you go slightly more, slightly larger in terms of the definition of the business?

Obviously, if it leapt to a million dollars, you may get some interactive problems. Generally speaking, if we were to increase it we would get a little bit better benefit. So you are looking at total dollars generated versus where you are spending the dollars. On the margin, moving it up dollar for dollar seems to be appropriate as a reaction in your opinion, Mr. Secretary?

Mr. SNOW. Well, and I think that fits in with the spending amount that has gone to, what, $325? You may have to move that up a little as we—but, no, I think there is merit in that, that point of view.

Chairman THOMAS. Incremental moves in those areas would be equally meritorious to what the President is suggesting?

Mr. SNOW. I have not run the numbers on that to know what the trade-offs are. I think directionally certainly you would get benefits.

Chairman THOMAS. Thank the gentleman. Does the gentleman from Texas, Mr. Brady, wish to inquire?

Mr. BRADY. Yes. Thank you, Mr. Chairman. Thank you, Mr. Secretary, for being here today. Earlier—I have two questions and a request. The first question: Earlier today you were asked repeatedly what the cost of war would be. It raises the question, what is the price of living in terror? It seems to me the Nations with the toughest economies are those who live under the constant fear of attack, thinking back to 9/11, how devastating that is and was. How damaging was that to our economy and how devastating would be another attack on America to our economy?

Mr. SNOW. Well, Congressman Brady, you are raising the right question here. This is something we have to do. We have to remove this threat from the American people. The cost of this, of the threat, is far greater than the cost of dealing with the threat. That is your point, I think, and I agree with you entirely.

Mr. BRADY. It seems to be. The alternative to the President's package can be summed up in this. We will stimulate the economy by sending out one time a $300 rebate check, and then we will pump up more government spending. It seems to me government has been on a very large spending spree over a number of recent years, and it hasn't stopped this recession from occurring. Why would more government spending help us move out of recession when it didn't stop us from getting in there in the first place?

Mr. SNOW. I think the evidence is pretty clear, and Chairman Greenspan testified to this, a stimulus package based on spending isn't a very effective way to advance the interest of jobs, job creation, or growth in the economy. It is an ineffective way to do that.

Mr. BRADY. So a final request. I support the President's package. It seems to me the best way to balance the budget, start paying down the debt again, and to preserve Social Security and Medicare is to get this economy growing. That has been your point repeatedly, and I think you are right on target.

In addition to that package, could you take a look at the proposal that I have introduced along with 50 Members of Congress to restore the sales tax deduction that was taken away in 1986?

What we are seeking to do is provide balance back to the Tax Code. What we do today is we provide a deduction for those who have a personal income tax in their State, but we don't allow taxpayers to States that pay their governments through a State sales tax. So in other words, you have two identical families paying with the exact same income, the exact same deductions, paying differently just because of where they happen to live. Our feeling is that this legislation would help stimulate the economy because for just an average family of four, a schoolteacher, someone who works at the bank with two kids, it would pump $300 to $400 into their family's account immediately. For those who live in States that have a personal income tax for the first time they have an option of choosing between the highest deduction, their income tax or their State tax.

Would you take a look at that proposal again just from a standpoint of would it help stimulate the economy and would it help make our Tax Code a little bit more fair?

Mr. SNOW. I would be delighted to do that. I think you raise a good question.

Mr. BRADY. Thank you, Mr. Secretary, Mr. Chairman.

Chairman THOMAS. Does the gentleman from Texas, Mr. Doggett, wish to inquire?

Mr. DOGGETT. Thank you, Mr. Secretary. Thank you, Mr. Chairman, and thank you, Mr. Secretary.

I think you have a really tough job. You are replacing a man who apparently was fired because he was too candid. As you are well aware of, former Secretary O'Neill has indicated that he would reject what you call the centerpiece of this tax plan and has said that the resources would be better used to shore up Social Security. I certainly don't blame you for evading Mr. Rangel's questions, because the last member of this Administration who made an estimate, even though it was a low-ball estimate, on the cost of the war in Iraq was fired also. His estimate was $100 to $200 billion, which was incredibly low for the years of occupation that will be involved here.

You have had to abandon your own prior record of opposing economic stimulus measures and your own record of opposing deficits, and now you are about to preside over the largest deficit in the history of America.

Instead of paying down the public debt, as we were doing when this Administration came into office—it wasn't just on paper; we were actually paying down the debt—you proposed to raise the debt ceiling. I think you are going to need an extension over at the Treasury Department because if this plan is going to be put into effect, it will soar above $10 trillion when you count in interest figures on this plan.

You also have a difficult job because never before in my memory has another prominent Republican—the Chairman of the Federal Reserve Board, Federal Reserve Bank, Mr. Greenspan, questioned the impact of one of President Bush's tax proposals and you have to explain that away also.

All of this, Mr. Secretary, occurs when the President is telling us here in Congress, and the American people, that he cannot keep his word with regard to education. He has come up short this year on the No Child Left Behind Act, which was one of our few bipartisan initiatives here. At a time when public schools in my town and all across America are freezing teacher hiring and cutting back education budgets, the President tells us we cannot afford any student financial assistance that we have already. So thousands of Americans will not get the support that they need to go to school.

I am as concerned as some of my colleagues about the cost of blood and money, about the land invasion of Iraq. I am concerned about what seems to be this Administration's war on reality. My question to you, and I think it is the same answer for all three parts of it, isn't it true, first, that every penny of this tax break that you are advocating will be paid for by borrowing from the American people?

Second, isn't it true that almost half of the American taxpaying households will get $256 or less from the proposal you are advocating?

Third, isn't it true that the firm that the President relied upon to predict the job figures you just testified about a few minutes ago, Macroeconomic Advisors of St. Louis, forecast that the plan that you are advocating could actually hurt the economy over the long term with higher interest rates, the same concern Mr. Greenspan had about crowding out private investment, and that the economy, if the plan were adopted, would actually be worse than if there had been no tax breaks enacted at all—that is, if you don't offset spending to make up for this and the President hasn't offset any spending?

Then, finally, I would ask you if it is also not true that less than 3 percent of the huge amount of money that you are proposing to incur in public debt in order to pay for these tax breaks, less than 3 percent of it will actually be spent this year and that it will have a minuscule stimulative effect this year?

Mr. SNOW. I will start with the latter one, that the spending impact in calendar year 2003 will be about $100 billion, sizeable enough to affect the economy; and after all, we are talking about a $10 trillion economy now. So you need to have spending of considerable size to affect it. On Macroeconomic—and it will produce jobs. I am confident of that, as I testified earlier.

Macroeconomic Advisors, they have a model that is good in the short term, but they unfortunately took it out to 2017 and the model's probity isn't as high way out then. I think they have got assumptions built in there that just conflict with reality. It is hard for me to understand how you could get the results they got from that model.

On Chairman Greenspan, I agree with most of what Chairman Greenspan said. He said he didn't want to see a stimulus package. I agree with that; we need a growth package. Stimulus packages, as we talked about earlier with Congressman Brady, don't really accomplish much, in my view.

The deficit, it is going to manageable. The Chairman himself, I think, said something to the effect that the fiscal problems we have at the moment are modest. The thing he is worried about are the fiscal problems out when the baby boomers retire, out in 2012 and 2014.

So basically I think I would be disagreeing with you on every one of your major points there.

Chairman THOMAS. The gentleman's time has expired. Does the gentleman from Kentucky, Mr. Lewis, wish to inquire?

Mr. LEWIS OF KENTUCKY. Thank you, Mr. Chairman. Mr. Secretary, there is an old adage, "Circumstances alter cases," and I think we find ourselves in a set of circumstances that were certainly beyond our control: the recession, an attack on our country, an emergency. President Bush said early on he was going to work to make sure that we cap a balanced budget in our country, but the circumstances altered the case.

Under these circumstances, what is the fastest way, the best way, we can start moving back to a balanced budget and start paying down the debt again?

I came here in 1994 with a desire to balance the budget. We did that in 1997. We passed a bill that balanced the budget; we did start paying down debt. Then unfortunate, sad circumstances led our Nation beyond our control. Now we are in this condition, how are we going to get out? I think this proposal is one good way to accomplish that. What would be your comment?

Mr. SNOW. My reaction is the same. The best way to get out of the situation we are in now is to grow, is to get on a higher growth path and get people back to work. As that happens, the government's revenues will rise as well.

We developed those surpluses—the surpluses were the product of a buoyant and growing economy, and the American economy has now been through an extraordinary set of jolts, really extraordinary—the recession, 9/11, the meltdown of the stock markets, the corporate governance scandals—and confidence isn't what it should be. The recovery is slower than it should be. That is understandable.

Circumstances have changed, and we need a set of economic policies that accommodate the current circumstances. I think this does that very well.

Mr. LEWIS OF KENTUCKY. I agree. Thank you.

Chairman THOMAS. Does the gentleman from Wisconsin, Mr. Ryan, wish to inquire?

Mr. RYAN. I do, Mr. Chairman, thank you. Mr. Secretary, one of the benefits of being low on the seniority totem pole is that you pretty much hear all the arguments as they come around to you. I have heard a few of them that I thought were very, very interesting.

On the distribution table, you hear this and I am going to quote something I read out of Time Magazine, quote, "Although Bush touted the fact that the average tax bill would shrink $1,083, almost half of all filers will get reductions of less than $100 according to the left-leaning Center on Budget and Policy Priorities," end quote. You heard that quote repeated all around here.

What is interesting about these distributional analyses is that they don't actually look at who pays taxes. So, if you are going to cut someone's taxes, you have to pay them in the first place to get their taxes cut. I know that is fairly logical. When you see that this tax plan brings the number of tax filers who never pay taxes to almost 40 million filers, that is about 69 million people, you have to take that into consideration. If you are going to get a tax cut, you have to pay taxes in the first place. So I think what you are seeing thrown around here is really sort of unfair, inaccurate, distortive distributional analyses that do not give a fair reading of the President's plan.

Another thing that I wanted to bring to your attention, if I could ask for that chart on dividends to be brought up. I just handed you a chart; it is the top one. I would like to ask you a couple of questions about the dividend proposal.

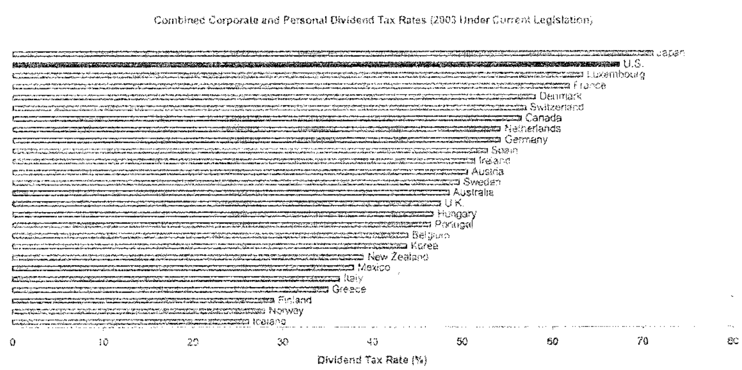
As you well know from our own personal experience, a high tax rate on dividends actually decreases the after-tax rate of return on investment. When you take a look at our economy, by definition—and you worked as an economist so I know you know that—our

economy, our GDP is broken down into three parts: consumption, investment and government spending.

Government spending, as my colleague Mr. Brady said, is at an all-time high. That is doing fine. If you want more spending, that is doing quite well. Consumption, on other hand, also has been doing fairly well; and many economists argue that consumption is the reason why our economy grew at 2.5 percentage points last year.

What is in decline in this economy is investment. Investment has declined eight consecutive quarters. So when you look at some of the more egregious taxes on investment, it seems to me the most egregious tax on investment, the greatest assault on capital in this country is the dividends tax. What this chart shows is that now that we work and operate in a competitive economy, in a global economy, you can see that the U.S. tax on dividends, both paid at the corporate and the personal rate, the combined tax on dividends, is the second highest in the industrialized world, next to Japan. So, while we are trying to compete and face the competitive pressures on our manufacturing businesses, our small businesses, from China, from Germany, from Japan, from all around, we see that we tax dividends higher than any other country in the world except for Japan, which is in its second decade of recession.

[The chart follows:]



Mr. RYAN. What I would like to ask you is, on this dividends proposal, could you walk me through how it also helps other non-dividend-paying taxes, how the step-up in basis actually helps all equity values and how it helps people who think that if they don't get a dividend, they aren't going to be helped by this.

As for my second question, a lot of critics are saying if we cut taxes and if they are not revenue-neutral tax cuts, they decrease the national savings rates. I think we are going to hear from an economist tomorrow who is actually going to come here and say cutting taxes decreases savings.

Could you address these kinds of allegations, as well—the charge that the positive effect of the Administration's tax cut proposal could actually reduce or wipe out its positive growth effects by de-

creasing national savings or the deficit and interest rate connection?

So, first, how this helps other equities than just dividend-paying stocks and then the national savings criticism.

Mr. SNOW. One of the interesting features of this proposal is how it affects capital generally. I think that is probably what your question is getting at.

Today, the Tax Code tilts in favor of debt. Broadly speaking, what we are trying to do here is to eliminate that tilt in favor of using debt, which is leading to too high debt-to-equity ratios, building in too much precariousness in the American business structure and raising corporate governance issues because companies don't have the incentive to reveal their real earning power through paying dividends.

Retaining earnings is also a good idea sometimes, and we don't want the scale to be tilted against retaining earnings in favor of paying dividends at the expense of retained earnings. So we have tried to be neutral. The way we have been neutral on this is to say that if you don't use your entire amount of dividends that you could pay out because there has been a prior tax on it, if you don't use that entire amount, the difference, what is left over, will go into the stock basis of your investors.

Take an example, $100 million of earnings, tax rate 35 percent, you end up with $65 million you can pay out under the President's proposal in dividends without a tax to the recipient. Suppose you want to keep $30 million of that $65 after you have paid out the $35. That $30 million is added to the tax basis, increases the basis of your shareholders.

Let us assume there are 30 million shares. That means for every one of those shares, the basis rises from $30 to $31. That $1 now is taken outside of the capital gains tax. So it has an effect on capital gains reductions as well as on dividends.

The argument on the savings mystifies me. I don't see how that could be good economics. The argument is, if you have got a deficit, then you are crowding out private capital. There is no crowding out of private capital when you have underemployment of all your resources in the economy. Whatever merit that might have if you are working in a full-employment economy, it has no merit when you are in an economy that is performing under its full potential. There simply won't be any crowding out. What we want to do is stimulate more private capital formation.

Chairman THOMAS. The gentleman's time has more than expired. Does the gentleman from Texas, Mr. Sandlin, wish to inquire?

Mr. SANDLIN. Yes, sir, Mr. Chairman. Thank you, sir. Mr. Secretary, thank you. Good to have you here. I will say, as Mr. Ryan has indicated, it is more difficult to have anything to ask toward the end, but we can only hope that the last will be first and the first will be last and go forward.

I appreciate your position that nothing should be taxed twice and agree with that. You did indicate that you felt everything should be taxed once, and is that correct.

Mr. SNOW. I think it is a general proposition—earnings, income, real income should be taxed once.

Mr. SANDLIN. Would that include efforts that are currently under way to go after corporations that locate offshore in an attempt to avoid corporate tax? Would you support trying to recover taxes on those revenues?

Mr. SNOW. I think the IRS does have a vigorous program under way. Looking at those, you are calling those inversions and tax shelters? I think if a tax shelter is inappropriate and is abusive, it ought to be addressed.

Mr. SANDLIN. If we eliminate the double tax on dividends, about the only money that I am aware of that would be double taxed would be wages, which would be subject to income tax and payroll tax; is that correct?

Mr. SNOW. Well, there is a dispute on whether or not the payroll tax is a tax or a payment for the purchase of that, but you could make the argument either way.

Mr. SANDLIN. Payroll tax, by definition, is a tax; is it not? Is it not a payroll tax?

Mr. SNOW. When I talk about a payroll tax in the Social Security sense or the Medicare sense, I am talking about a tax which is really a payment to secure an insurance program.

Mr. SANDLIN. You are currently proposing a reduction in double taxes, as you call them, on dividends, but there is no proposed reduction in payroll tax is there?

Mr. SNOW. No, there is not, and for good reason, I think.

Mr. SANDLIN. Let me ask you on behalf of my senior citizens, seniors that hold stock in their 401(k), if withdrawals are made from the 401(k), they will not be given the benefits or the protections of the lack of double taxation; is that correct?

Mr. SNOW. This is a 401(k) in which they have got a deduction; they put the money in and then it builds up interest free and tax free during that interim period, and then they pay a tax at the end.

Mr. SANDLIN. So they will not be afforded that protection, though? You said accumulate stock.

Mr. SNOW. I think they get the equivalency of it, because they have a tax deduction when they make the initial investment.

Mr. SANDLIN. I understand the deduction, but when a withdrawal is made—I have been asked this by many constituents: If you are a current investor and you earn a dividend, you would get the protection if you receive that money now. If you make a withdrawal from your 401(k) you will not be afforded that protection, correct?

Mr. SNOW. Let me give you an answer in detail for the record, because there is a complicated explanation as to why that produces an equivalency.

Mr. SANDLIN. Let me ask you just a few more questions. So the higher-income present investors will receive a tax break by not having to pay income tax on current dividends, but working people who earn wages, they will pay a double tax on wage and payroll; and senior citizens who withdraw funding from a 401(k), they too will pay taxes on that withdrawal; is that correct?

Mr. SNOW. Everybody who gets investors in the equity markets will find themselves not paying that double taxation.

Mr. SANDLIN. Except if that person withdraws money from his 401(k), he is going to pay tax on it.

Mr. SNOW. He has already taken a deduction. That is why that is complicated. That produces an equivalency.

Mr. SANDLIN. I am just a country lawyer from Texas, but I understand that. I am making the point when he takes the money out, he is going to pay income tax on that money.

Mr. SNOW. He will pay it, but he already has a deduction on it, and it produces the same tax effect. Let me give you the memorandum and then we can discuss it. That was the same question I had when I was first told that.

Mr. SANDLIN. Until the Administration told you to change.

Mr. SNOW. This was an internal debate within the Treasury Department.

Mr. SANDLIN. My mother is a retired school teacher just like your mother. I was surprised she was able to accumulate a portfolio of stock, a modest one. My mother with her modest income was—her money is in certificates of deposit earning very little, as you might imagine. She will not get any protection on her CD return, as opposed to an investor who gets that protection; is that correct?

Mr. SNOW. Yeah. That has been taxed once. That is a single tax.

Mr. SHAW [Presiding.] Mr. Hulshof.

Mr. HULSHOF. Thanks, Mr. Chairman. Mr. Secretary, welcome. Thanks for your patience and I appreciate these series of hearings. Perhaps those tuning in might have their eyes glazed over a bit, but I think this has been a very useful economic discussion; and I think you have made a strong case for ending the double taxation on dividends.

I would like to take it, however, from the classroom and maybe bring it back to the real world a bit and follow up on a question asked by Mrs. Johnson earlier.

You indicated that the low-income housing tax credit, that there would be a modest effect if this plan were implemented as far as the low-income housing tax credit. How does that square with last week's release of the Ernst & Young (E&Y) report that indicates that will be a 35-percent reduction in the availability of affordable housing?

Mr. SNOW. I have not had a chance to review that in real—in detail. It has been reviewed by the staff at Treasury. The conclusion there is that the E&Y study greatly overstated the impact on that credit and, basically, that E&Y missed a few things that were relevant in their study.

Mr. HULSHOF. I appreciate that, because as you can tell, there are certain things in the Tax Code that do enjoy bipartisan support. I hope that that is something—Ms. Olson, I know you have been often quoted too on that issue, and hopefully we can get to some resolution.

The other thing I would point to, and I absolutely agree with you as you make the case that there is a tilt in favor of debt over equity, just as I believe the Tax Code for individual taxpayers produces a tilt in favor of consumption over savings.

Having said that, though, I also—and as one of the few Members, I think, on this Committee that still does our family's taxes without the use of accountants or other tax advisors, I want to talk a little bit about complexity.

It has been reported that computing the amount of dividends, or following through the dividends as far as the taxability of those dividends, is going to be somewhat complex in that companies would have to establish excludable distribution accounts in which they would have to record not only corporate income that has been taxed, and then companies would have to track that income as fully taxed or partially taxed or that is untaxed, and then inform shareholders about what portion.

You know, I know on my 1040 and across the country, line 8 says, What is your interest income, put it here—Uncle Sam wants his share—and then under that, dividend income.

Then you go to Schedule B and that Schedule B depends, of course, on the 1099. So complexity, when it comes to where the rubber meets the road. Again, we can talk theoretically. Again, I am convinced by the economic arguments.

What assurances can you give on the complexity issue?

Mr. SNOW. On the complexity issue, the first line of defense is the corporations themselves who have a great deal of experience. I used to run one of those organizations, and I am confident that the corporate treasuries and corporate finance departments can readily—and tax departments can readily do at the corporate level what they need to do with respect to the REBAs and the CREBAs and the excludable dividend amounts (EDAs) and all those things that you are making reference to.

Then the question is, if the corporation can do it readily—and I really think they can readily do that—how much more complexity is there from the point of view of the individual taxpayer who now has this basis that can be adjusted and so on? With respect to the dividend itself, there is no more complexity; in fact, it is less complex because there is one less tax to worry about at the investor level.

I am assured that the broker-dealer networks and the mutual funds can readily accommodate the information and make it available for their investors. Just as they keep your basis of today, your mutual fund will keep your basis in the stock, your broker-dealer will keep your basis in the stock. My conversations with people indicate that the mutual fund industry, the asset management people, the broker-dealers will be able to readily accommodate that. A little work on their part, but from the point of view of the investor it will be seamless.

Mr. SHAW. The gentleman's time has expired. Mr. Secretary, I would like to join my colleagues and welcome you back to our hearing. It is a delight to hear you fend off questions as well as answer questions.

A few minutes ago, the gentleman from Texas, Mr. Doggett made this comment and I wrote it down. He said that we should use these dollars to shore up Social Security. I am a little confused by that comment as to where those dollars would be placed. The Social Security trust fund doesn't keep any dollars. It either pays them out or converts them into Treasury bills and puts them back into the general fund. If the gentleman is thinking about setting up individual savings accounts for every American worker, then he has got an ear from me, because I am looking for people to assist us in that because that is exactly what we should do. I will yield.

Mr. DOGGETT. I was only quoting Secretary O'Neill, the Secretary's predecessor, who said he opposed this dividend plan because he thought these moneys would be needed to shore up Social Security. Perhaps what he had in mind is what many of us are concerned about, that if we incur another umpteen trillion dollars in public debt, we will have less resources to strengthen Social Security, whatever form it might take in the future.

Mr. SHAW. Reclaiming my time, I would say that we are going to have enough payroll taxes to take care of our Social Security obligations until 2016. Now, beginning at 2016, at that point, we are going to be looking for dollars if we don't start planning ahead now. Quite frankly, that would be one of the greatest stimuluses we could possibly give to the stock market is to allow every American worker to actually own stock in their own IRA. I would be delighted to look for partners on the Democrat side to work with me in that particular area.

Mr. Secretary, I want to comment, too, on the plan. We talk about stimuluses versus growth. I don't think anybody in this room would dare to try to make an argument that you can tax your way out of a recession. You cannot. You can invest and encourage investment, and that is your growth. You can give tax relief, which is the stimulus. I think that by accelerating the child credit, that is going to be a great stimulus and, I think, some of the other things involved in there.

I think your dividend plan is excellent as far as growth. Your plan as far as the small business investment is growth. That is the only way you are going to create jobs in this country is through capital investment.

When you look at the greatest economic power in the world, the United States, as being the largest taxer in the world of capital, second only to Japan, and we know how their economy is going, I think you have to really have to have reason to pause and wonder which direction we are going.

We also have spent an extraordinary amount of time, and both Democrats and Republicans have been very concerned about the corporate inversions to the extent that we are looking at ways to penalize corporations for leaving this country, which I think is, in some instances, appropriate; but I think also we should look at ourselves and see what we can do to encourage investment, what we can do to encourage moneys from outside the United States to return to the United States and be invested in our businesses so we can get jobs. That is tremendously important.

One other thing that I would like to comment on, and we keep talking about what this is going to cost. Now, as I understand the scoring, none of this takes into account the growth or the taxes that are going to come into the U.S. Department of the Treasury as a result of job creation, as a result of investment, as a result of this stimulus.

Would you like to comment on that?

Mr. SNOW. Yes, Mr. Chairman, I would. The way this is scored, we have taken all of the costs of the lost revenues and that is the $690-some billion, but we have not done any of the offsets; and clearly, there will be some sizeable offsets here as people get back

to work, as the economy grows faster, as small business becomes more profitable.

As the economy performs better, there will be a sizeable payback to the revenue stream of the Federal Government. The estimates I have seen put that in the 30 to 40 percent range of feedback in terms of revenues. So the number you are looking at is really a much larger and, unrealistically, a large deficit number. The actual deficit will be orders of magnitude smaller than that.

Mr. SHAW. Thank you.

Mr. SNOW. Could I add one more thought, Mr. Chairman? You made a very important point about the inversions and people seeking to avoid taxes.

One reason they seek to avoid taxes is the impact of things like the double taxation of dividends. As we lower tax rates, the incentives—and that clearly does this—as we take earnings and income out of the tax system, corporations have far less incentive to engage in the tax shelter activity that so many find offensive.

Mr. SHAW. Ms. Tubbs Jones?

Ms. TUBBS JONES. Thank you, Mr. Chairman. Mr. Snow, it is nice to see you again, sir. Secretary Snow, I want to pick up where we left off. We were talking about double dividend taxing, as you claim it to be, and its impact on low-income housing. When you left the last time, I made some statements to you, and you said you really weren't sure about that.

Have you done any homework since you left, sir, that you can discuss with me the impact of the dividend tax credit on low-income housing, sir?

Mr. SNOW. We have.

Ms. TUBBS JONES. Understand I only have 5 minutes, so if you give me a short answer, I would appreciate it.

Mr. SNOW. I will give you an answer for the record as well, but the short answer is, there will be some effect but not large.

Ms. TUBBS JONES. Let me ask you this. You are aware in 1986 the low-income housing credit was created to generate equity for affordable rental housing?

Mr. SNOW. Yes.

Ms. TUBBS JONES. In the early days, high net worth individuals bought these credits as tax shelters, correct? Then the credits were made permanent in 1993, and large public companies got interested in them as a way to shelter earnings over a 10-year period. In fact, low-income housing credits, as well as empowerment zones and some of the community renewable provisions enacted in 2000, the newer markets initiatives of the Clinton Administration and the qualifying zone academy bonds, which are bonds that allow the companies to buy the bonds tax free in order for schools to be renovated, will all be affected by the dividend tax cut. Is that a correct statement?

Mr. SNOW. I don't think in any major way.

Ms. TUBBS JONES. Well, you know what? You just said that the cost of war will be relatively small as compared to the GDP. When you say in a "major way," for a school system like Cleveland, where they were able to renovate schools, it could be a major way.

Mr. SNOW. Let me tell you why I don't think it will be a major way.

Ms. TUBBS JONES. Short answer.

Mr. SNOW. The corporations will still have incentives to invest in these.

Ms. TUBBS JONES. They won't have these incentives.

Mr. SNOW. They will still have incentives because it is unlikely they will use up all of their EDA.

Ms. TUBBS JONES. You know what? It is wonderful to hear you talk about "It is unlikely" and "It is probably," but the people out in the streets who don't have any jobs and who are struggling to make ends to meet don't like these terms, "unlikely" or otherwise. Let me go on to something.

Mr. SNOW. I am confident we will create a lot more jobs for those people.

Ms. TUBBS JONES. You did say the cost of war will be relatively small as compared to the GDP. In a number, what is the cost of war, sir?

Mr. SNOW. Of course, my first answer is we hope to avoid war.

Ms. TUBBS JONES. I don't want that answer because that is not answering my question. I don't mean to be disrespectful, but I have sat through 25 people where you have given that answer. My question is, what is the cost of war as compared to the GDP in numbers, as you use it, sir?

Mr. SNOW. I don't——

Ms. TUBBS JONES. You don't know, do you?

Mr. SNOW. I don't know. I don't know that we are having a war.

Ms. TUBBS JONES. If it is not a war, then tell me what is it costing us to have Blackhawk helicopters all over in Iraq? How much are the tankers going to cost? We have troop transports, LHAs, LSTs. We have military salaries, food, clothing, ammunitions. Every day in my congressional district, somebody is being deployed. What is that costing?

So if it is not called war, what is it and how much does it cost and where does it fit in the budget, sir?

Mr. SNOW. Well, as we discussed earlier, whatever the cost is, and I don't know.

Ms. TUBBS JONES. You are the Secretary of the Treasury and you don't know what sending—not the war, but the Blackhawk helicopters, the tankers, the ships, the military salaries, the food, clothing, ammunition, the base maintenance, the carrier ships, you don't know what that costs?

Mr. SNOW. No, I don't, but I am sure somebody in the government does.

Ms. TUBBS JONES. Could you get that answer for me tomorrow?

Mr. SNOW. I don't know that I know how to get the answer.

Ms. TUBBS JONES. You are the Secretary of the Treasury and you can't get that answer and you don't know where it is? What is your job, sir, as Secretary of Treasury?

Mr. SNOW. Well, I think it is to worry about the fundamentals of the American economy and see that people have jobs and that we can grow the economy.

Ms. TUBBS JONES. To understand how much money is in the Treasury that you are worrying about, right, and how that money is expended; is that correct?

Mr. SNOW. That money will be in a defense appropriation.

Ms. TUBBS JONES. No, but, sir, it is not about a defense appropriation. This money is being spent today and for the past 90, 120 days, and that is not an appropriation coming up. That is money that is being expended today.

Mr. SNOW. Congresswoman, money isn't spent that isn't appropriated. So it has to be in an appropriation.

Ms. TUBBS JONES. Sir, you are not making a correct statement. Money is spent that isn't appropriated because if it were not being spent, if it were not appropriated, we wouldn't be having this discussion. If it were appropriated, we wouldn't be having this discussion, excuse me, because there was no appropriation for a buildup for a war in Iraq.

Mr. SNOW. Ultimately, the Congress has to approve what the executive branch——

Ms. TUBBS JONES. We haven't approved this and that was a whisper in your ear. I want you to answer my question tomorrow.

Chairman THOMAS [Presiding.] The gentlewoman's time has expired. I would tell the gentlewoman that appropriations to the Department of Defense oftentimes have a broad basis for expenditures, but they first are authorized and then appropriated under, oftentimes, broad headings, which are then used for specific purposes.

Ms. TUBBS JONES. Mr. Chairman, I thank you for the response, but my question was to the Secretary.

Chairman THOMAS. I understand. Does the gentleman from Florida, Mr. Foley, wish to inquire?

Mr. FOLEY. Thank you, Mr. Chairman. Thank you, Mr. Snow, for attempting to appear here today as Secretary of Defense and Treasury.

Ms. TUBBS JONES. You may think it is funny, but I don't.

Mr. FOLEY. Thank you. We are delighted you are here. It seems some people have amnesia in the building, who have been talking about deficits. I got elected in 1994, and it seems 40 years of Democratic rule brought us to trillions of dollars of deficit that nobody seems to remember.

If the former President of the United States had operated and pursued Osama bin Laden, given numerous information about his whereabouts and including the fact that the Sudanese attempted to hand him over, we may not need to calculate the effects of war in this country. We certainly wouldn't have to look at the carnage in New York, the Pentagon and Pennsylvania had we pursued Osama bin Laden with the same veracity as we did Bill Gates and his cheap software.

Let me suggest to you, did not President Kennedy attempt to stimulate the 1960s economy by authoring and providing to the Congress a significant tax reduction?

Mr. SNOW. He did indeed.

Mr. FOLEY. Wouldn't it be fair to suggest, when we cut capital gains tax rates, that we, in fact, stimulated economic activity and cash flow to the Treasury?

Mr. SNOW. I think that is fair to say. As I recall the President's comment, when challenged, he said, "A rising tide lifts all boats,"

something—I was a young man, but I thought it captured the essence of tax reform.

Mr. FOLEY. We cut taxes on capital gains in the mid-'90s, and we found the same stimulative effect despite a constant barrage from then-Secretary Rubin as to the negative impact. It was actually a very stimulative impact. Do you not see future opportunities, as we reduce tax rates, to incur that same kind of revenue enhancement to the Treasury?

Mr. SNOW. I don't think we will ever balance the budget unless we have a strong, growing economy. It is a necessary condition, and we won't get there without it.

Mr. FOLEY. You touched on, a little bit, and I wanted to underscore the concerns on low-income housing credits as well as wind energy credits.

There are some impacts to those credits that I would like you to look at carefully to find a way, in fact, if we could not neutralize the adverse effects while retaining the benefits of the dividend plan. I think there is a way we can craft a proposal.

Mr. SNOW. We are making an effort to understand the impact and try to quantify it, and once we do, we will be in a position to engage in that subject with you.

Mr. FOLEY. There have been some inquiries from banks and others why they would be unfairly treated under the proposal of the dividend plan. Isn't it correct that a CD, that the bank deducts the cost of that interest to the debtor, if you will, from their balance sheet, they take that off of earnings; so it is taxed, there is a taxation? So they obviously have a beneficial financial transaction in deducting that cost from business.

Mr. SNOW. That's right.

Mr. FOLEY. Would it be fair to assume—and first let me quantify because I grew up under the notion that dividend stocks were for widows and orphans because it provided safety and security in their retirement; is that fair to assume?

Mr. SNOW. Yes. The profile of investors in dividend stocks is different than the profile of investors in municipals or other things.

Mr. FOLEY. Some have suggested that IRAs, 401(k)s and others wouldn't be treated fairly in the dividend plan since they pay no taxes within their basket.

I would tend to disagree by suggesting—once again using the quote, "A rising tide lifts all boats," that if you, in fact, reduce taxes on those dividends, you increase the likelihood of investors' preference for those stocks, thereby increasing the value of all the stocks. So if your basket contains those stocks, you will see your 401(k)s, IRAs and other accounts rise in value; would you not?

Mr. SNOW. Absolutely. That is what you would expect.

Mr. FOLEY. So there is a stimulative economic-driven incentive for this Committee to carefully consider that.

Mr. SNOW. As I said earlier, I think one of the beneficial aspects of this is that it will enhance equity values whether they are in or out of retirement plans or 401(k)s.

Mr. FOLEY. Obviously as we move forward, the public is concerned about the values of their equities. I think we all are. I assume you and the President and his chief advisers spend a lot of time thinking about the plight of the average investor on a daily

basis, because it absolutely impacts the growth and stability of our marketplace.

Can you share with us some of those pressing concerns?

Mr. SNOW. We have become an investor society. We have any number of television networks now dedicated entirely to reporting the stock news. Even the networks that don't dedicate themselves to reporting market activity have a little column underneath the main story that is always running the stock indices.

We are an investment society. It is a wonderful thing that so many Americans are participants in the marketplace, in the equity markets. The loss of equity values has—which has gone on now for 3 years has taken the wind out of a lot of peoples' sails. It has dampened their confidence. Corporate scandals did that as well.

I think we need to reinstill confidence in equity markets, and one way you do that is to give equities a boost. They are going to get a boost because the added earning power, the added after-tax earning power of corporate America, especially as they pay more dividends, will get recapitalized and reflected in their market values. That will raise the value of corporate equities.

Of course, taking the retained earnings out of corporate capital gains taxes will also mean that the shareholders will have more after-tax earnings in that case when they sell the equity.

Chairman THOMAS. The gentleman's time has expired. Does the gentleman from North Dakota wish to inquire?

Mr. POMEROY. Thank you, Mr. Chairman. I would begin by just saying that this is a place where bipartisan debate gets hot sometimes, but to suggest that the carnage in New York is the responsibility of the prior Administration is way out of bounds, way out of bounds, and should not have been said by the gentleman from Florida.

Mr. Secretary, having observed the 1990s, we were paying down the deficit, we were reducing the deficit. The economy was growing and doing well. This decade, so far, we have been growing the deficit and the economy has not performed well.

It is my understanding that the Treasury Department will be advancing a proposal to raise the borrowing limit of this country within this calendar year; is that correct?

Mr. SNOW. Yes.

Mr. POMEROY. I think that is what is causing some of us concern about this package. We are trying to get our hands around exactly what might be involved in driving the deficits even deeper than they are already at a steep rate of increase.

Does the cost of the package before us count additional borrowing costs that we will have to make in light of revenue that will not be received by the Treasury? I am told it could be as high as an additional $254 billion in added borrowing costs.

Mr. SNOW. The $695 doesn't include either the borrowing costs or the feedback to the revenue stream of the Federal Government.

Mr. POMEROY. Will there be other tax cut proposals advanced by the Administration?

Ms. Olson has been broadly quoted relative to a significant proposal that would allow the affluent people to save tens of thousands of dollars in tax-free accounts. I wonder if this is a proposal the Administration will be making.

Mr. SNOW. This is the centerpiece proposal of the Administration.

Mr. POMEROY. Are there two categories, centerpiece proposals and kind of add-ons, or how are we to evaluate this? Will there will be additional tax proposals? The President has talked, for example, about making the tax cuts permanent. Is that going to be another set of tax cut proposals being advanced?

Mr. SNOW. Right now, we are talking about the growth package, and that is the centerpiece of the President's program.

Mr. POMEROY. Kind of reminds me of how I eat cake. I take the piece out of the pan. I come back and take another piece out of the pan. Pretty soon, I have eaten the whole damn pan of cake.

You are coming after one tax cut today. You are going to come in after another tax cut later—not the centerpiece of the growth package, but to make the tax cuts a permanent package. Ms. Olson has been talking about this proposal to not tax the savings of the most affluent, tens of thousands of dollars of their savings of the most affluent.

Are all of those matters going to be advanced for our consideration?

Mr. SNOW. I would hope so, because it is all good——

Mr. POMEROY. Mr. Secretary, I am trying to run an adding tab here. Now, we have been talking a lot about the cost of the war and maybe there won't be a war. I certainly hope there won't be a war. In any event, we have got to acknowledge we have expended an awful lot of money not initially anticipated in the budget for the Pentagon that we had earlier appropriated.

I believe that the Administration will be advancing a supplemental appropriation to cover these costs. Do you have any information on that? I am not saying the size, but can we expect a supplemental appropriation?

Mr. SNOW. I think it is entirely conceivable, but I am not aware.

Mr. POMEROY. From what I hear, it certainly is entirely conceivable, in fact, to the extent that all of this effort being waged up to this point and prepositioning around Iraq was not anticipated and was not funded. So, we are going to have a very significant bill coming on that one.

Now, the combined total of all that you are advancing is extraordinarily significant. You are talking about a dividend proposal, 75 percent of which goes to the wealthiest 1 percent of households and, let me see, 50 percent goes to the wealthiest 1 percent of households and 75 percent goes to the wealthiest 5 percent of households. Clearly, this isn't much of an immediate stimulus.

So for the 2 million people that have lost their jobs over the last couple of years, this does not offer either immediate relief—and when you talk about growing back to the 2 million jobs, you are talking about the year 2005. So now you are talking about immediately creating the kind of jobs to get these people back to work, the 2 million that have lost their jobs. So you are talking about a very extraordinary hit to the Treasury, especially when we anticipate what else you are going to be bringing and the cost of the war with Iraq and very little by way of stimulus effect to create jobs now.

You can see where our concern is coming from. I will be happy to hear the Secretary's response.

Chairman THOMAS. The gentleman's time has expired.

Mr. SNOW. You and I have a difference of opinion on the impact of the package. We think it will have an immediate and direct impact, creating 2 million jobs in the next 2 years. While a deficit is unfortunate, to have any deficit at all, it is small, it is modest and it is manageable and will not have any real effect on interest rates.

Chairman THOMAS. Does the gentleman from Pennsylvania wish to inquire, which would be the final inquiry?

Mr. ENGLISH. I would consider it a privilege. Mr. Secretary, in my 9 years on this Committee, it is refreshing to see a Treasury Secretary coming forward with such a break-the-mold idea on tax policy as the centerpiece of a plan to rebuild the economy and encourage economic growth. I very much want to credit the Administration for thinking outside of the box on tax policy and looking for ways of giving the economy some substantial forward movement.

If I could, I would like to redirect the questioning to get back to what I thought was the point of the hearing, which was to focus on the growth potential in the Administration's program. I have several questions for which I would actually like answers, so I will give you time to answer them.

First of all, I know the Administration was encouraged in the name of economic growth to also look at reducing the capital gains tax rate. Rather than exploring why the Administration didn't pursue that as an option, I wonder if you would comment on how the provision eliminating the double taxation of dividends might affect the taxation of capital gains and how this potentially could have growth consequences.

Mr. SNOW. Thank you very much for that opportunity. That is a very important, Congressman, feature of this proposal.

Under the proposal, any income of the corporation that has had a prior corporate tax applied to it can be paid out as dividends and not taxed at the investor level. In many cases, companies will pay out only a portion of the eligible money as dividends. Then the question is, what happens to the rest of that?

Under the President's proposal, the portion of that total amount that could be paid out as dividends, and prior-taxed and won't be taxed to the investor, will go into the stock basis to raise the basis of the stock. What that means, of course, then, is that the individual investor will have excluded from capital gains that amount.

Just a simple example sort of illustrates it. You have got $100 million of earnings. It is all taxed at the 35-percent rate. It leaves $65 million to be paid out. Company says, well, we will pay out $35 million. That $35 million will not be again taxed, but neither will the retained earnings. It has $30 million that it retains in earnings, assuming they have got 30 million shares, $1 per share would—for every share, the basis would rise by $1, and that $1 would not be subject to capital gains tax.

So we are making a very far-reaching effort here to reduce the taxation of capital to make sure that America doesn't, when this legislation is enacted, stand at the very top of that chart showing what country has the highest tax rates for capital.

Mr. ENGLISH. Many of us in Congress have been concerned over the last year, year-and-a-half in the wake of many of the corporate governance scandals to encourage the transparency of corporate activities and specifically corporate finances. By eliminating the double taxation of corporate dividends, how does this affect the transparency of corporate operations?

You have been a CEO. What kind of incentive does this create?

Mr. SNOW. It creates a very strong incentive to pay dividends out. There can't be any doubt of the fact that if this proposal is adopted, there will be an increase in dividends paid by companies who today pay dividends, they will go up, and companies who don't pay dividends will decide to pay dividends.

The marketplace will demand it, because what will happen here, I am convinced, Congressman, is that the companies who are paying dividends will find their market value goes up because the after-tax earnings stream from those companies will get capitalized. They are now producing more returns to investors. Investors will go to those stocks and drive the prices up.

Other companies will say, we want to get in on that. We want to reward our shareholders. In this day and age where there have been so many questions raised about accounting numbers and what is the core earning power of a company, to encourage payment of dividends, which is the best and purest test of the underlying earning power of a company, is a marvelous idea. It will help eliminate a lot of this concern that investors have about, what do these numbers really mean. A company that starts paying out 20, 30, 35, 40, 45, 50 percent of its dividends will be sending the market a clear signal that it has got confidence in its underlying earning power.

Now, you can fudge numbers a little bit, but you can't fudge cash.

Mr. ENGLISH. Thank you Mr. Secretary. Your testimony is most eloquent.

Chairman THOMAS. Mr. Secretary, thank you very much, especially on behalf of the Committee for staying the entire time.

You are right, profits are an opinion, cash is a fact. Frankly, we need to have a bit more of that as people make decisions in this country whether you are an individual or a corporation. I believe that is the intended purpose of the President's underlying bill.

The Committee stands in recess.

[Whereupon, at 4:55 p.m., the hearing was recessed, to reconvene on Wednesday, March 5, 2003, at 2:00 p.m.]

PRESIDENT'S ECONOMIC GROWTH PROPOSALS

WEDNESDAY, MARCH 5, 2003

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 2:20 p.m., in room 1100 Longworth House Office Building, Hon. Bill Thomas (Chairman of the Committee) presiding.

Chairman THOMAS. If our guests can find seats, please. What you might assume was an interruption in the regular order was, in fact, the regular order. The Members were over voting.

Today, we begin a second day of a four-part hearing to examine the President's initiative for expanding the economic growth our Nation needs to create jobs and providing the resources needed to secure the future for working Americans.

We begin with the panel that would examine the benefits of reducing individual income tax rates, including relief from the so-called marriage penalty, and accelerating the increase in the child tax credit that would be given to parents. We are pleased to have as part of this panel Mr. James Glassman, who is currently a resident fellow with the American Enterprise Institute. I recall a column written in the Washington Post, and for a brief period of time, his appearance on one of the more enlightened talking-head programs, as I recall, and thought you should have stayed on longer. Also, John Castellani, president of the Business Roundtable, and William Gale, co-director of the Tax Policy Center with the Brookings Institution.

The second panel will discuss the various effects of the proposal to eliminate the double taxation of dividends. I would hasten to say that since the package is a package, I don't expect to be mutually exclusive in the discussion of these issues, but we have tried to create some placement of emphasis for focus in moving forward. To help us better understand the implications of that particular proposal, we have the Honorable Frank Keating, who is the CEO of the American Council of Life Insurers (perhaps some of us know him more as the former Governor of Oklahoma); John Schaefer, President and Chief Operating Officer of the Individual Investor Group with Morgan Stanley & Co., and Chairman of the Securities Industry Association (SIA); Ron Stack, who is Managing Director and Head of Finance for Lehman Brothers, and Chairman of the Municipal Securities Division for the Bond Market Association; and Alan Hevesi, who is the New York State Comptroller.

The witnesses today will give us a chance, based upon their testimony and our questions, to examine from several viewpoints the President's proposal. We are pleased to have such distinguished panels with us. As the Members ask questions, I do hope that we can retain a modicum of civility so that we generate slightly more light than heat.

Before our first panel, I would like to recognize the gentleman from New York, Mr. Rangel, for any comments he might wish to make.

[The opening statement of Chairman Thomas follows:]

Opening Statement of the Honorable Bill Thomas, Chairman, and a Representative in Congress from the State of California

Good afternoon. Today, we begin our second day of a four-part hearing to examine the President's initiative for expanding the economic growth our Nation needs to create jobs and providing the resources needed to secure the future for working Americans.

We begin with a panel that will examine the benefits of reducing individual income tax rates, including relief from the unfair marriage penalty, and accelerating the increase in the child tax credit to give help to parents. We are pleased to have James Glassman, a Resident Fellow with the American Enterprise Institute; John Castellani, President of The Business Roundtable; and William Gale, Co-Director of the Tax Policy Center with the Brookings Institute.

Our second panel will discuss the various affects of the proposal to eliminate the double taxation of dividends. To help us better understand the implications of this proposal, we have the Honorable Frank Keating, CEO of the American Council for Life Insurers and former Governor of Oklahoma; John Schaefer, President and Chief Operating Officer of the Individual Investor Group with Morgan Stanley & Company and Chairman of the Securities Industry Association; Ronald Stack, Managing Director and Head of Finance for Lehman Brothers, Inc. and Chairman of the Municipal Securities Division for the Bond Market Association; and Alan Hevesi, New York's State Comptroller. The witnesses today will give us a chance to examine several different viewpoints, as well as possible alternatives.

We are fortunate to have such a distinguished panel of experts testifying to help us better comprehend the outcomes and effects of the President's proposal. I hope Members will take full advantage of the opportunity presented before us this afternoon.

Before we hear from our first panel, I would like to recognize the gentleman from New York, Mr. Rangel, for any comments he would like to make at this time.

Mr. RANGEL. Thank you, and I join with you in hoping that having professional economists that are not politically motivated that they might be able to share some light on the impact of the President's proposal to this Committee and how it is going to affect local and State governments and existing Federal programs.

This is especially so since the Administration has not seen fit to incorporate the cost of the war into its budget proposal. Like you, we don't know whether we are going to be at war at all or for 4 days, 4 weeks, 4 years. We also really don't know what the impact of the deficit is going to be on our economy, as well as so many of these proposals being long-term rather than short-term stimulus. Knowing how the Roundtable and so many other business groups have always been concerned about the size of the deficit and the impact on economic growth, it would be good to receive this morning a nonpartisan, professional review of the budget that is before us.

I thank you so much for taking time out to respond to our invitation.

Chairman THOMAS. I thank the gentleman. I will tell each of you that any written remarks that you may have will be made a part of the record. You can address this as you see fit in the time that you have. You need to turn the microphones on. They are very unidirectional and you need to speak directly into them, and I would invite your remarks to try to stay within the timeframe so

that each Member can have their opportunity to ask you questions if they so desire.

Let's start with Mr. Glassman and move from my left to my right, your right to your left.

STATEMENT OF JAMES K. GLASSMAN, HOST, TECHCENTRALSTATION.COM, AND RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. GLASSMAN. Thank you, Mr. Chairman, thank you for inviting me today, Mr. Rangel, Members of the Committee. My name is James K. Glassman. I am a resident fellow at the American Enterprise Institute and host of the website TechCentralStation.com. In addition, for more than 20 years, I have been writing about personal investing, currently as a syndicated columnist for the Washington Post.

A major focus of my work has been the impact of public policy, including tax policy, on small investors. I am in the process of establishing a new organization, Shareholders United, to represent the interests of small investors.

Today, speaking only for myself, I will address the effects of President Bush's tax proposals, which are highly beneficial. In order to understand the impact, it is necessary to look first very briefly at the sweeping changes in the investment environment in the United States.

Over the past 20 years, personal investing has undergone a revolution, creating what Robert J. Samuelson of the Washington Post has called "one of the great social movements." In 1983, only 16 million households owned stocks, either as individual shares or through mutual funds. By 2002, the figure had climbed to 53 million—in other words, roughly half the families in the United States.

There are 84 million shareholders compared with 16 million union members and 43 million senior citizens over the age of 60.

One reason for the boom is the boom in mutual funds, which are also vehicles for the ownership of bonds and debt securities. The proportion of households owning mutual funds of any sort has risen from 6 percent in 1980 to 50 percent in 2002.

Ownership of financial assets has broadened dramatically. For example, the fastest-growing demographic sectors for mutual funds are: one, families making between $25,000 and $35,000 a year; and, two, households headed by persons 25 to 34 years old. Particularly, rapid growth has occurred among African American and Hispanic families. Investing is no longer the exclusive domain of the white, the rich, and the middle-aged. Ownership of financial assets has continued to thrive despite the recent sharp decline in stock prices. This revolution has brought about a profound change. Americans no longer simply work for owners of capital assets. They are now owners themselves.

Now, let me turn to taxes. The U.S. Tax Code continues to encourage consumption over savings and investment. The Economist magazine recently stated in an editorial, "America seriously overtaxes savings and seriously undertaxes consumption. This inhibits the accumulation of capital and . . . . makes the economy more fragile."

My perspective in this testimony, however, is not macroeconomic. It is from the bottom up—from the point of view of individual investors.

With taxes what they are, many of these investors wonder why they should save and invest beyond their 401(k) plans, and the majority of them do not even have such plans.

In January, President Bush announced a tax plan to speed up the recovery from the 2001 recession, provide an economic insurance policy against war and terrorism, and strengthen the economy for the long term. The most significant feature is ending the double taxation of corporate dividends and not apply capital gains taxes to profits attributable to retained earnings.

The dividend proposal addresses an anomaly in the tax law that taxes dividend income more than any other kind of income. The idea of eliminating one of the layers of taxation of dividends is not a new idea. In fact, it was advanced as long ago as 1936 by President Franklin D. Roosevelt. Double taxation creates serious economic distortions. It encourages companies to borrow to excess and to hoard their earnings rather than paying them out to shareholders. Thus, the law hurts small investors by encouraging inefficiency and depleting the value of their holdings.

In recent years, the effects have been dramatic. For example, in 2002, the lowest proportion of large companies on record paid dividends. The proportion of earnings that the average firm sends to shareholders in the form of dividends has fallen from more than half to about one-third over the last two decades. Research by economist James Poturba predicts that this payout ratio will rise back to the mid-50-percent region if double taxation is ended.

Dividend payments mean less volatility for investors. Even in a year in which a stock might fall 20 percent in price, a stock is likely to continue paying its dividend, providing steady income and a buffer against capital losses. Since 2000, for example, dividend-paying stocks have outperformed non-dividend payers by more than 40 percentage points.

Recent research cites “the poor job that the average company does when investing the cash that it would pay out as dividends. Therefore, it is better for the company to distribute its earnings to shareholders.”

The President’s proposal would encourage more corporations to distribute dividends, or at least to disclose in greater detail why they choose not to. A dividend is also in most cases a more accurate manifestation of a company’s financial health than the paper profits reported to government authorities. An old saying going back to the 19th century holds that “earnings are an opinion, but cash is a fact.” Ending double taxation would, thus, improve corporate governance by making corporate performance more transparent.

Beyond that, the policy, of course, will increase the return on small investors’ stock investments. The White House estimates that 35 million Americans currently receive taxable dividends and will benefit from the changes. Half of those are senior citizens. Dividend income from taxable investments will rise between 40 percent and 80 percent.

Investors who hold stock in tax-deferred investments or in Roth IRAs will also benefit from a rise in the price of the shares them-

selves since taxable investors will bid up the share price. How much? Economists differ, but a rise in price is undeniable, probably on the order of 8 to 10 percent.

Chairman THOMAS. Mr. Glassman, 5 minutes occurs very quickly when you are having fun. Can you sum up?

Mr. GLASSMAN. Thank you, sir.

In addition, by accelerating the tax rate reductions enacted in 2001, the proposal will increase the current income that small investors receive from all financial assets, both stocks and bonds. This step will have the same effect as the elimination of double taxation. It will boost after-tax returns and increase the value of capital.

Finally, on the brink of war, and at a time when we now have the highest tax rates on corporate income of any Nation other than Japan, the United States needs to give investors every incentive to commit their dollars to investments that will boost growth and increase jobs. The President's plan does that powerfully, efficiently, and fairly.

Thank you.

[The prepared statement of Mr. Glassman follows:]

Statement of James K. Glassman, Host, TechCentralStation.com, and Resident Fellow, American Enterprise Institute

My name is James K. Glassman. I am a resident fellow at the American Enterprise Institute and host of the website TechCentralStation.com. In addition, for more than 20 years, I have been writing about personal investing as a columnist for The Reader's Digest, Worth magazine, the International Herald Tribune, New York Daily News and many other publications. I am currently a syndicated financial columnist for the Washington Post and am the author of two books on investing. The more recent, *The Secret Code of the Superior Investor* (Crown), was recently named one of the 10 best financial books of 2002 by Barron's.

A major focus of my work has been the impact of public policy, including tax policy, on small investors. With several associates, I am in the process of establishing a new organization that I will chair, Shareholders United, which will represent the interests of small investors.

Today, speaking only for myself, I will address the effects of President Bush's tax-reduction proposals, which I believe are highly beneficial. But, in order to assess the full impact of those proposals, it is first necessary to examine the sweeping changes that have occurred in the investment environment in the United States.

The Rise of the Shareholder Society

Over the past 20 years, personal investing has undergone a democratic revolution, creating what Robert J. Samuelson of the Washington Post called "one of the great social movements." [1] In 1983, only 16 million households owned stocks—either as individual shares or through mutual funds. By 2002, the figure had climbed to 53 million households. In other words, roughly half the families in the United States are owners of American businesses listed on the major exchanges.[2]

Of all U.S. stockholders, 89 percent own at least some stocks through mutual funds, which are also vehicles for the ownership of bonds and other debt securities. The proportion of households owning mutual funds of any sort has risen has risen from 6 percent in 1980 to 50 percent in 2002.[3]

Ownership of financial assets has broadened dramatically. For example, the fastest-growing demographic sectors for mutual funds are: 1) families making between $25,000 and $35,000 a year, where the proportion of fund ownership went from 28 percent in 1998 to 36 percent in 2002, and 2) households headed by persons aged 25 to 34 years old, where fund ownership over the same period rose from 42 pecent

[1] Robert J. Samuelson, "Stocks Without Risks?" *Newsweek,* Nov. 11, 1999.

[2] "Equity Ownership in America," 2002, report based on several data sources, including the Investment Company Institute and the Securities Industry Association. Published by the American Council for Capital Formation, Washington, October 2002. See www.accf.org.

[3] "U.S. Household Ownership of Mutual Funds in 2002," Investment Company Institute, Washington, October 2002. See www.ici.org.

to 48 percent. Currently, 48 percent of households with incomes from $35,000 to $50,000 own mutual funds, as do 57 percent of households headed by a person aged 35 to 44.[4]

Similarly, a recent Federal Reserve report found that the median value of mutual funds held by non-whites and Hispanics in 2001 was $17,500; the value of stocks, $8,000; bonds, $7,600; and certificates of deposit, $9,000.[5] The Fed data show that, for the average American family, financial assets now comprise 42 percent of total assets, compared with 32 percent 10 years ago.[6]

In other words, investing is no longer the exclusive domain of the white, the rich and the middle-aged.

Ownership of financial assets has continued to thrive despite the sharp decline in stock prices over the past three years.[7] For example, the benchmark Standard & Poor's 500-Stock Index lost 9 percent of its value in 2000 and 12 percent in 2001, but the number of households owning mutual funds rose between January 1999 and January 2002 from 49 million to 53 million.[8] Those are the most current ownership figures available, but we know that in 2002, investors withdrew a net of $27 billion from equity mutual funds—only about 1 percent of the total assets of those funds—despite the worst year for stocks since 1974. Investors also added a net of $140 billion to bond mutual funds.[9]

This revolution has brought a profound change: Americans no longer simply work for owners of capital assets; they are now owners themselves. "As capitalism expands," wrote my colleague Ben J. Wattenberg, "a lot of 'them' become 'us.' [Stock ownership] brings us all together as stakeholders in common."[10] In 1977, the year before the 401(k) was created, there were 298 work stoppages that idled 1.2 million workers for 21.2 million working days. Twenty years later, there were only 29 strikes that idled 339,000 workers for 4.5 million working days.[11] In addition to encouraging cooperation, ownership of financial assets "appears to have . . . encouraged an orientation towards the future—the investor's own and his family's."[12]

Tax Policy Encourages Broad Ownership of Financial Assets

A study by the Joint Economic Committee[13] found that the main reasons for the broadening of ownership of financial assets were, first, the rise of mutual funds and, second, important changes in tax law, such as the advent of Individual Retirement Accounts and 401(k) accounts and the decline in capital-gains tax rates.

> It [the IRA] was the first real incentive for a great number of Americans to put money away for the long term. And these were generally people who up until then hadn't seen themselves as having any control over the long-term.[14]

Still, the Tax Code continues to encourage consumption over savings and investment. "Taking the overall tax haul as given," The Economist magazine recently stated in an editorial, "America seriously overtaxes savings and seriously undertaxes consumption. This inhibits the accumulation of capital and probably depresses long-term growth. It also encourages excess indebtedness, which makes the economy more fragile."[15]

My perspective in this testimony, however, is not macroeconomic. It is from the bottom up—from the point of view of individual small investors.

Many of these investors wonder why they should save and invest beyond their 401(k) plans—and the majority of them do not even have such plans. Their salaries are first taxed at ordinary income rates; then, if they can save anything to invest

[4] Ibid.

[5] "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances," Federal Reserve Board, p. 13. See www.federalreserve.gov.

[6] Ibid, p. 9.

[7] 2000–2002 comprised the third-worst three-year period in stock market history. The broad market index dropped 40 percent, a figure exceeded only by 1930–1932 and 1929–1931.

[8] S&P figures from *2002 Yearbook*, Ibbotson Associates, Chicago. Ownershp data from "Equity Ownership," op. cit.

[9] "Trends in Mutual Fund Investing," December 2002, Investment Company Institute statistics; press release, Jan. 30, 2003.

[10] Ben J. Wattenberg, "Capitalism for the Masses," Baltimore Sun, Jan. 9, 1997.

[11] "Investor Fact Sheet," American Shareholders Association, Washington. See www.americanshareholders.com.

[12] Richard Nadler, "The Rise of Worker Capitalism," Cato Policy Analysis No. 359, Nov. 1, 1999.

[13] "The Roots of Broadened Stock Ownership," Joint Economic Committee, April 2000. See www.house.gov/jec.

[14] Joseph Nocera, *A Piece of the Action: How the Middle Class Joined the Money Class* (New York, 1994), p. 288.

[15] "Who dares wins," The Ecomonist, Jan. 11, 2003, p. 10.

in financial assets, the income (dividends and interest) from those investments are also taxed at ordinary rates; if they re-invest what is left of that income after taxes, the dividends and interest are taxed once more. If they sell the assets at a profit, capital gains taxes apply. And if they manage to pass along any of their investments at death, then estate taxes may apply. Americans wonder why they shouldn't consume (in which case, they're taxed only once, on the initial salary) rather than save and invest.

The Bush Tax Plan

In January, President Bush announced a tax plan to speed up the recovery from the 2001 recession, provide an economic insurance policy against war and terror, and strengthen the economy for the long term. The two most significant features were ending the double-taxation of corporate dividends and making rate reduction from the 2001 tax law effective immediately rather than phasing them in (in 2004 and 2006, as the law originally provided). Both of these measures will encourage savings and investment and broaden the shareholder society—not by bestowing special favors but by removing impediments.

Double Taxation of Dividends

The dividend proposal addresses an anomaly in the tax law. Suppose a company earns $1 in profits that it wants to pass on to its owners, that is, its public shareholders. The $1 is first taxed at the corporate level at a rate of around 40 percent, including both federal and state corporate income taxes. That leaves 60 cents. The 60 cents is then sent to shareholders in the form of dividends. The shareholders pay, depending on their tax bracket, taxes that are fairly similar—in many cases, 40 percent or more. That leaves 36 cents. So, of the original $1 in profits, 64 cents go to taxes.

The idea of eliminating one of the layers of taxation is not a new idea. In fact, it was embraced as long ago as 1936 by President Franklin D. Roosevelt, whose Treasury Secretary, Henry Morgenthau, proposed ending taxes on income at the corporate level for all profits that were distributed to shareholders.[16] Roosevelt said that the measure "would constitute distinct progress in tax reform." It ultimately failed, of course. The Bush proposal retains taxes at the corporate level but eliminates them at the individual level. The effect is the same.

Double taxation creates serious economic distortions. For example, it encourages companies to borrow (since profits that are used to pay interest on debt are taxed only once, not twice), and it encourages them to retain their earnings rather than paying them out to shareholders. Since current tax policy promotes such inefficiencies, it hurts small investors by depleting the value of their holdings.

In recent years, the effects have been dramatic—in part because the gap between capital gains rates (now up to 20 percent) and ordinary income rates (now up to 38.6 percent) has risen. For example, in 2002, only 351 companies paid any dividend at all, among the 500 large firms that comprise the S&P 500.[17] That is the lowest proportion on record. More important, the percentage of profits that the average firm sends to shareholders in the form of dividends has fallen from 55 percent to 36 percent over the past two decades.[18]

Dividend payments mean less volatility for investors. Even in a year in which a stock might fall 20 percent in price, a stock is likely to continue paying its dividend, providing steady income and a buffer against capital losses.

In addition, academic research, starting with the work of Michael Jensen of Harvard in 1986, indicates strongly that "the more cash that companies have now (beyond what is needed for current projects), the less efficient they will be in the future."[19]

In 2002, the stocks of S&P 500 companies that paid dividends fell 13.3 percent, on average, while the stock non-dividend payers declined 30.3 percent.[20] While this

[16] A fascinating discussion of FDR's advocacy of ending double taxation of dividends is found in a memorandum to "Friends of ABC," the American Business Conference, Washington, D.C., by John Endean, who himself draws from John M. Blum, *From the Morgenthau Diaries, Volume One: Years of Crisis, 1928–1938* (Boston, 1959), pp. 305–319.

[17] "2002 Review," Standard & Poor's, U.S. Indices, p. 4.

[18] The average dividend payout ratio (dividends/earnings) for stocks covered by the Value Line Investment Survey was 55 percent between 1977 and 1986 and 36 percent for 2000, the most recent year for statistics. The decline has been consistent and dramatic. "A Long-Term Perspective: Dow Jones Industrial Average 1920–2000," Value Line Publishing, Inc., New York.

[19] Michael C. Jensen, "The Agency Costs of Free Cash Flow: Corporate Finance and Takeovers," American Economic Review, Vol. 76, No. 2 (May, 1986). The quotation is not from the paper, but from a paraphrase by Mark Hulbert, "In a Twist, High Dividends Are Now a Predictor of Growth," New York Times, Nov. 17, 2002.

[20] "2002 Review," Standard & Poor's, op. cit.

difference is particularly extreme, it is clear that companies that keep their cash often use it unwisely. A new study by Robert Arnott and Clifford S. Asness has found:

> For the overall stock market between 1871 and 2001, corporate profits grew fastest in the 10 years following the calendar years in which companies had the highest average dividend payout ratio. In contrast, the 10-year real earnings growth rate was the lowest following years with the lowest average payout ratio.[21]

The authors believe that "the primary cause" of this result is "the poor job that the average company does when investing the cash that it would pay out as dividends. Therefore, it is better for the company to distribute its earnings to shareholders."[22]

Currently, managers have an excuse and an incentive to hoard their earnings. In fact, it is surprising that they pay out even one-third of their profits to shareholders, considering the tax laws. But eliminate double taxation of dividends and the excuse disappears. The proposal "would encourage more corporations to distribute dividends or, at least, disclose in greater detail whey they choose not to—a point worth the attention of those demanding greater managerial accountability in the use of what Louis Brandeis called 'other people's money.'"[23]

Consider a company that earns $4 per share in profits after taxes. It retains $2 for reinvesting in the business and sends $2 to shareholders in the form of dividends. The shareholders can then choose: reinvest in the company themselves because they like what management is doing, or use the money to invest in another company. Without the dividend, the only action the shareholder can take is to sell his or her stock altogether.

A dividend is also, in most cases, a more accurate manifestation of a company's financial health than the paper profits reported to government authorities. An old saying, going back to at least the 19th century, holds that "earnings are opinion, but cash is a fact." I continually encourage my readers to look at the consistency with which a company pays—and raises—its dividend. Such activity tells far more about the soundness of the firm than rising earnings, which, as we have seen, are easy to manipulate. Dividends can't be faked. It's true that companies can borrow to pay dividends, but under the president's proposal, such leveraged dividends are taxable to investors—a sure sign that something fishy is going on.

Consider Enron Corp. Between 1997 and 2000, Enron increased its reported earnings per share by a total of 69 percent (from 87 cents to $1.47), but its dividends per share rose only 9 percent (from 46 cents to 50 cents).[24] That might have been a tip-off that the company was suffering a cash squeeze. But investors ignored the evidence, in part because they simply have not taken dividends very seriously in recent years, thanks to the tax disincentives. That will change if the Bush proposal becomes law.

Almost exactly a year ago, I testified in front of the House Financial Services Committee in a hearing whose subject was, "How to Protect Investors Against Another Enron." I stated at the time:

> Cash dividends are the clearest, most transparent evidence of corporate profits. An investor who sees dividends increasing every year can, properly, have confidence in a company. . . . Ending double taxation of dividends would increase payouts and vastly increase investor confidence. I realize that this matter goes beyond the committee's jurisdiction, but it is probably the single most important legislative step that can be taken to protect shareholders.[25]

Beyond corporate governance, ending the double taxation of dividends will have a powerful and beneficial effect: It will increase the return on every small investor's stock investments. The White House estimates that 35 million Americans currently

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[21] Hulbert, op. cit.

[22] Ibid.

[23] Endean, American Business Conference, op. cit.

[24] Data from Value Line's final one-page analysis of Enron, by Sigourney B. Romaine, Dec. 21, 2001. Also worth nothing is that Enron's cash flow was negative (that is, capital expenditures, not to mention dividends, exceeded incoming cash) for each of the years 1997–2000. The Value Line Investment Survey, New York.

[25] James K. Glassman, "How to Protect Investors Against Another Enron," testimony before a hearing on H.R. 3763, "The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002," Financial Services Committee, U.S. House Of Representatives, March 13, 2002.

receive taxable dividends and will benefit from the changes. Half of those Americans are senior citizens.[26]

Consider a person in a 30 percent tax bracket who owns 100 shares of stock in a company that currently pays a dividend of $1 per share. Assume the dividend payout does not increase. Under current law, the investor pockets $70 after taxes; if the Bush proposal passes, the investor pockets the full $100. That is an increase of 43 percent. Now assume that the company, as a result of the new tax incentive, boosts its payout from $1 to $1.25—which is actually a more modest increase than would occur if the current payout ratio merely reverted to the mean of previous decades. Now, the investor pockets $125 instead of $70—an increase of 79 percent.

But what about investors who hold stock in tax-deferred accounts or in Roth IRAs, which are untaxed? Almost certainly, such investors would benefit from a rise in the price of the shares themselves since each of those shares would now produce more after-tax income for taxable investors. *Those* investors would bid up the share price. How much? Economists differ, but a rise in price is undeniable.

Perhaps more important, eliminating the double taxation of dividends would provide an incentive for investors to increase their savings outside limited tax-advantaged vehicles like 401(k) plans and IRAs, decreasing their dependency on Social Security and encouraging them to put money aside for non-retirement expenses, including education, home purchases and renovation, travel or starting their own businesses.

At the very least, the proposal turns the attention of investors toward dividends, which in recent years have not received the respect they deserve. While dividends have declined as a percentage of stock prices (yield), they remain a critical factor in achieving high returns over time. For example, a study found that $1,000 invested in the S&P 500 index on June 30, 1982, became $16,597 (without taxes) by Sept. 30, 2001. But approximately 40 percent of those gains came from reinvesting dividends back into the stocks of the index.[27]

Acceleration of Rate Reductions

In 2001, Congress passed and the President signed into law a bill that reduced tax rates across the board. In fact, proportional cuts were greater at the low end than the high. The bottom rate was cut to 10 percent from 15 percent (a decline of one-third) while the top rate was cut from 39.6 percent to 35 percent (less than one-eighth). In addition, the cut to 10 percent happened immediately while other rates were scheduled to be reduced slowly, with completion by 2006. In an effort to boost the recovery, the President has proposed making all remaining cuts effective now, retroactive to Jan. 1, 2003.

By accelerating the tax-rate reductions, the proposal would increase the current income that small investors receive from their financial assets, both equities and debt. Some of the increased income would be consumed in purchases of goods and services and some would go back into investment. But the overall effect would be to increase the incentives for future investment by increasing returns at the margin—that is, at the point of deciding how to commit a dollar in hand.

Again, the math is simple. Take an investor in a 39.6 percent tax bracket before the 2001 law. The rate is now 38.6 percent, but, if the President's proposal is accepted, the investor's rate drops immediately to 35 percent. If she had invested a few years ago in a $10,000 Treasury bond paying 6 percent interest, she will this year, if the law does not change, receive $600 before taxes and $368.40 after taxes. With the acceleration, she will pocket $390—an increase of 6 percent. Another way to say this is that her after-tax return on the investment will rise from 3.7 percent to 3.9 percent. That's a significant increase in a low interest-rate environment. Similarly, an investor who is trying to decide what to do with $10,000 will have more incentive to invest than to consume since returns are higher.

Two objections are frequently raised. The first is that the benefits of acceleration go to higher earning Americans. Proportionally, the opposite is true. The bottom bracket gets the biggest cut; the other brackets get roughly the same cut. In terms of actual dollar savings, of course, the higher-earners will, in many cases, get more, but the tax plan offers other cuts aimed at middle-income Americans including remediation for the "marriage penalty" and higher child credits. As an example, the Treasury cites "a married couple with two children and income of $60,000." Such

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[26] "Fact Sheet: The President's Proposal to end the Double Tax on Corporate Earnings," U.S. Department of the Treasury, press release, Jan. 14, 2003. See www.treasury.gov.

[27] "Fading Dividends Could Make a Comeback," T. Rowe Price Report, Baltimore, Fall 2001, p. 6.

a family will see taxes decline under the President's proposal "by $900 (from $3,750 to $2,850) in 2003, a decline of 24 percent." [28]

As for the highest earners getting more dollar savings: The latest Internal Revenue Service data show that the top 5 percent of taxpayers (with incomes above $121,000) pay 56 percent of all individual income taxes—even though they earn only 34 percent of all income. By contrast, the 50 percent of taxpayers with the lowest incomes (below $26,000) pay just 4 percent of the individual income taxes—with 13 percent of all income.[29] Any across-the-board cut, or even a cut skewed toward lower earners, will by necessity produce large savings for higher earners.

Higher earners are also more likely to save and invest. But low- and middle-income Americans need incentives, too. According to the Fed, in 2001, the median family in the 90th to 100th percentile of income held $161,000 in unrealized capital gains (that is, stock and bond profits), up from $75,000 in 1995. (That 2001 figure is probably lower now, with the decline of the stock market, but it is still substantial.) By contrast, the median family in the 40th to 60th percentile held just $9,500 in unrealized capital gains, up from $4,300 but still a minuscule number.[30]

The President's proposals will almost certainly boost the economy, adding to the value of the stock holdings of more than 50 million American families and spurring more capital investment and job creation. But, just as important, they will encourage families to make prudent purchases of financial assets—stocks and bonds for the long term—to provide them with more comfortable and fruitful lives.

Using static accounting methodology, the tax cuts represent less than one-half of one percent of the Gross Domestic Product that the U.S. is expected to generate over the next 10 years. That is a small price to pay for stronger growth, more jobs, and sounder retirements.

Thank you.

Chairman THOMAS. Thank you very much, Mr. Glassman. Mr. Castellani?

STATEMENT OF JOHN J. CASTELLANI, PRESIDENT, BUSINESS ROUNDTABLE

Mr. CASTELLANI. Thank you, Mr. Chairman. I am pleased to be here this afternoon to testify before the Committee.

The Business Roundtable, as you know, is an association of CEOs of major corporations with a combined workforce of 10 million employees in the United States and representing $3.7 trillion in annual revenues. Although we are in the business of creating jobs and contributing to economic growth, we have serious concerns about our ability to do these things in this fragile economic environment.

The CEOs of the Business Roundtable feel that the U.S. economy is not growing to its potential. Late last year, we surveyed our members about their business plans for 2003. The survey showed that few CEOs expected robust growth this year and raised serious concerns for American workers, companies, and the overall economy.

Let me give you three specific examples of the results of that survey.

First, 89 percent of our members said that they expected employment in their companies to stay the same or drop in 2003;

Second, 64 percent are expecting GDP growth rates of less than 2 percent for this year;

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[28] "Examples of Tax Relief in 2003 Under the President's Growth Package," U.S. Department of the Treasury, op. cit.

[29] "Tax Bites," table of Federal Individual Income Taxes by Income Class, Tax Foundation, Washington, D.C., www.taxfoundation.org.

[30] "Recent Changes in U.S. Family Finances," op. cit., p. 20.

Third, 81 percent expect their capital expenditures to be flat or decline.

Consumer demand and consumer confidence has been undermined by the overhang of our Nation's war on terrorism, the potential for a war with Iraq, and the decline in stock market valuations. Our CEOs feel that business investment will only return when there is sufficient consumer demand to exhaust the existing capacity in the U.S. economy. Only by increasing demand will we return to a level that supports investment and, more importantly, supports job growth. We feel we need to ignite consumer confidence and stimulate consumer spending.

That is why we are urging the enactment of an economic growth package. It must be, in our view, large in size, focus on consumer demand, and focus on restoring investor confidence. These are the actions we believe will jump-start the economy.

The President's economic growth and jobs proposal, as it has been reflected in the Chairman's introduction of H.R. 2, is, in our view, precisely the kind of boost the economy needs. If enacted, it will significantly stimulate the economy in the short term and boost long-term economic growth.

According to the results of the study conducted for the Business Roundtable by PricewaterhouseCoopers, using the widely supported macroeconomic model housed at the University of Maryland, H.R. 2, if enacted, would create jobs. The study shows it would create an average of 1.8 million jobs in each of the next 2 years and then average a creation of 1.2 million jobs per year for the next 5 years. It also shows that it would boost GDP in the United States by 2.4 percent by the end of 2004. Working consumers will have more money to spend and more confidence to spend it on goods and services.

By accelerating the 2001 tax rate cuts, the marriage penalty reduction, and the child tax credit increase, and by eliminating the double taxation of dividends, the proposal will not only provide an immediate boost to the U.S. economy, it will also add millions of jobs, increase investor confidence, and ensure long-term growth. Importantly, the elimination of the double taxation of dividends will have the single most positive impact on economic growth.

In addition to creating an average of 500,000 jobs per year over the next 5 years from this provision alone, the elimination of the double taxation of dividends has three important and multiplying effects:

First, it abolishes the double taxation of dividends, and by doing so it will spur consumer spending by increasing the after-tax income of stock investors. It will put more money in the hands of individuals because shareholders will no longer bear the unfair burden of paying taxes twice on the same income.

Second, eliminating the double taxation of dividends will change corporate behavior. It will provide an incentive for companies to boost their dividend payments to shareholders, and by our estimate in this model, it would increase by 4 percentage points over the 10 years.

Third, while it is difficult to predict stock market reaction, even the most conservative analysts predict significant increases in stock prices.

All three combined will not only benefit the broad spectrum of the economy that received dividends, particularly those people who depend on it for their retirement, but would benefit all of those funds that are invested in equities: 401(k)s, IRAs, private and public pension funds. Indeed, all sectors of the economy will benefit.

We urge this Committee and the Congress to move quickly to enact an economic growth plan that will give an immediate boost to the economy and put people back to work. The President's plan, and H.R. 2, is the best means for our companies to create jobs, spur business investment, ignite economic growth. It is the right prescription for this ailing economy. Thank you.

[The prepared statement of Mr. Castellani follows:]

Statement of John J. Castellani, President, Business Roundtable

My name is John J. Castellani. I am President of The Business Roundtable, an association of CEOs of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues. It is my pleasure to present the testimony of The Business Roundtable today in support of the President's economic growth and job creation package.

Overview

The Business Roundtable believes it is critically important for Congress to adopt a jobs and economic growth plan that will put more cash in the pockets of consumers, stimulate demand, create jobs, and get the world's strongest, most resilient economy moving again.

The economy is not performing up to its potential. Last November, The Business Roundtable conducted a survey of its 150 members, which cross all sectors of the economy, and we asked them what assumptions about employment, capital spending and economic growth they were imbedding in their business plans for 2003. In summary, the results raised serious concerns for American workers, companies and the overall economy.

- 60 percent of CEOs expect their company's employment to drop in 2003; 28 percent expect it to remain the same, and 11 percent expect employment growth.
- 57 percent of CEOs expect their U.S. capital expenditures in 2003 to be the same as 2002 levels, while 24 percent expect a decline. Only 19 percent expect higher capital spending.
- 64 percent of the CEOs are expecting GDP growth rates of less than 2 percent in their 2003 planning, while 36 percent expect GDP growth of more than 2 percent. By comparison, the average annual GDP growth over the past decade has been 3.2 percent.
- 19 percent of CEOs expect their 2003 sales to be flat compared with 2002, while 9 percent expect sales to be lower. Seventy-one percent of the CEOs expect higher sales in 2003.

The BRT survey of CEOs reinforces a series of economic data released over the past several months that indicates a mixed economic performance and an unstable recovery. Consumer sentiment fell this month to a nine-year low. The gross domestic product (GDP) rose by a mere 1.4 percent in the fourth quarter of 2002—the smallest gain since 2001—when it could be growing at 4–5 percent.

That is why last November, the BRT urged the President and Congress to take immediate action on a large economic growth package aimed at consumers. Business cannot create demand, so we need to ignite consumer confidence and consumer spending. The war on terrorism and fear of war with Iraq, and depressed equity valuations all have combined to undermine consumer confidence and push demand down. What the U.S. economy needs is significant and immediate tax relief for consumers.

The President's Economic Growth Plan

The President's economic growth and job creation package provides exactly the kind of boost our economy needs. It will do this by accelerating the 10 percent bracket expansion and rate reductions, with AMT hold-harmless relief; accelerating the marriage penalty reduction and child tax credit increase; and eliminating the unfair double taxation of dividends.

The President's plan, if enacted, will significantly stimulate the economy in the short-term and boost long-term economic growth. According to the results of a study conducted for The Business Roundtable by PricewaterhouseCoopers (PwC) using the widely-supported Inforum LIFT macroeconomic model housed at the University of Maryland (a copy is attached to this testimony), it will create an average of 1.8 million new jobs in each of the next two years and an average of 1.2 million new jobs per year for the next five years.

To put that in perspective, there are approximately 1.5 million fewer people employed today than the pre-recession high of 2 years ago, and we estimate that enactment of the President's growth package would put just as many people back to work in the first year.

The President's plan would, according to our study, boost the gross domestic product in the U.S. economy by 2.4 percent by the end of 2004. Working consumers will have more money to spend and more confidence to spend it on goods and services.

Eliminating the Double Taxation of Corporate Dividends

The dividend component of the President's plan, according to the BRT/PwC study, will have the single most positive impact on economic growth in both the short term and the long term. The dividend proposal contributes half of the plan's resulting job and GDP growth over five years. As a result, companies will be more likely to invest in new equipment, build new plants and develop new products, which will sustain economic growth and create jobs.

Abolishing the unfair double taxation of dividends will spur consumer spending by increasing the after-tax income of stock investors in three ways. First, it will put more money in the hands of individuals because shareholders from all income levels will pay less in taxes. Second, it will cause companies to increase their dividend payments to shareholders (by an estimated four percentage points). Third, it will put upward pressure on equity valuations.

Eliminating the double taxation of dividends will change corporate behavior. Under present-law, retained earnings are preferred because they are taxed at the lower capital gains rate while dividends are subject to the higher individual income tax rates. Under the President's plan, dividends would be tax-free to shareholders. While this same tax treatment would apply to retained earnings, shareholders are likely to prefer immediate cash in their pockets in the form of dividends.

Critics of the dividend component of the President's plan have suggested that it would only help companies that pay dividends and individuals who invest outside tax advantaged retirement accounts.

But the resulting increase in equity valuations would benefit companies and investors as a whole. In addition to boosting consumer confidence through greater wealth, increased equity valuation would benefit college and university endowments, IRAs, corporate and public pensions and all savings. Companies that do not have to fund their pensions will have additional operating capital to invest, resulting in more profits and increased stock prices.

The economic benefits are further multiplied when shareholders increase their spending on goods and services, which provides new income to other households. The increase in income leads to more demand, and producers will need to step up their hiring and capital spending in order to meet the increased demand. Because of this "multiplier effect," an initial $1 increase in cash income—because of the reduced level of taxation and increase in the dividend payout rate—will result in more than $1 of new income throughout the economy.

Budget Deficits and Fiscal Responsibility

The Business Roundtable acknowledges the importance of federal budget deficits, but also understands the importance of a healthy economy. Short-term budget deficits are understandable when there is below-optimal economic growth and a need to stimulate economic growth by allowing individuals to keep more of what they earn.

We believe the President's plan is fiscally responsible. Under the plan, deficits would start at 2.8 percent of GDP and decline to 1.4 percent by 2008, and average 2 percent during 2003–2008. The economy can handle deficits of that relative size. Deficits averaged three percent of GDP during the 1970s and 1980s.

The primary cause of the current deficit situation is declining revenues due to the 2001 recession and the anemic growth coming out of the recession. The key to returning to a balanced budget is to return to higher growth rates by stimulating the employment of underutilized resources in the economy (i.e., people and plant and equipment).

According to the BRT study, one-third of the projected 10-year static deficit increase resulting from enactment of the President's plan would be eliminated as a result of the increased economic growth derived from the plan.

At that level, the return on the government's investment in additional GDP would be 340 percent. On the dividend component alone, the return on the government's investment would be 630 percent. So we prefer to view the President's economic growth package as an investment in our economy.

Conclusion

We urge Congress to move quickly to enact an economic growth plan that will give an immediate boost to the economy and put people back to work. The President's plan is the best means for sustaining new job creation, business investment, and economic growth, both in the short term and in the long term. It is the right prescription for an ailing economy.

Chairman THOMAS. Thank you, Mr. Castellani. Welcome, Mr. Gale.

STATEMENT OF WILLIAM G. GALE, CO-DIRECTOR, TAX POLICY CENTER, BROOKINGS INSTITUTION

Mr. GALE. Thank you very much, Mr. Chairman, Mr. Rangel, and distinguished Members of this Committee. Thank you for inviting me to testify this afternoon. It is an honor to appear before this Committee.

My comments will focus on the economic effects of the President's job and growth package as well as the broader context and the overall budget situation.

Elsewhere I have described the President's tax proposals as an answer in search of a question. I believe the package overall is poorly designed and poorly conceived for almost any useful purpose.

First, it is not a good way to stimulate the economy in the short run. Economists are fairly united on this, and even the Administration admits this on occasion.

Second, it is not a good way to stimulate economic growth in the medium or longer term. A variety of studies show this. In particular, I draw your attention to a study by Macroeconomic Advisers, which is not a commissioned study. It was a study that they did on their own. They found no effect on GDP over 5 years. They found an increase in interest rates, which ultimately would raise the cost of capital and reduce productivity growth.

It may seem strange that a tax cut on dividends might have this effect, but the logic is pretty straightforward. First of all, the tax cut would reduce national saving; that is, it would reduce government saving by more than it would increase private saving. That in turn reduces our future national income. Just like a household that saves less has less income in the future, a country that saves less has less income in the future, too.

Second, although the proposal would definitely help the incorporated sector, it would definitely hurt other sectors of the economy, like small business and housing. They would be hurt because the way the proposal works would be to make corporate equities more attractive relative to all other forms of investment than it currently is. So you would expect funds to move from the small business sector, the unincorporated sector, into the incorporated

sector. You would expect them to move especially from the housing sector, which is interest sensitive, to the incorporated sector. You would expect slowdowns in the unincorporated and housing parts of the economy.

The slowdown would occur both because of the shift in resources from unincorporated sectors and debt to equity and because there would be an increase in interest rates. I don't want to get into a debate about whether budget deficits increase interest rates. Actually, I would be happy to, but I am not going to here. There is another reason that interest rates would go up, even if budget deficits have no effect on interest rates. That is, as money moves from bonds to equity, the value of bonds is going to fall. As the value of bonds falls, the interest rate has to rise by definition. So to the extent that the proposal is capable of drawing funds into the corporate sector, it is going to raise interest rates, and that will hurt the other sectors of the economy, even if deficits have no effect on interest rates.

Third, the proposal is not even a good way to fix the corporate tax system. It is overly complex. It gives the dividend tax break in the wrong place. It gives windfalls to existing capital, but directs little of its gains to new investment. In short, it does the easy part of corporate tax reform. It cuts taxes while completely ignoring the hard part, which is the base-broadening, loophole-closing part. This is not what the Treasury focused on in 1992. The Treasury in 1992 focused on revenue neutral, distributionally neutral corporate integration. I think everyone is in favor of that. That is not what this proposal is.

Let me turn now to the broader budget package. The broader budget package has larger and equally regressive tax cuts, and it has reductions in spending programs that benefit low-income households, children's health, child care and education. The No Child Left Behind Act is funded at a level that is $9 billion below the amount authorized for 2004.

At the same time, the budget makes unrealistic assumptions. It completely ignores the AMT. It uses a 5-year budget window, but then proposes tax cuts that are twice the size of the cost of fixing Social Security but that don't start until after the 5-year budget window. Even under the Administration's assumptions, we have structural deficits as far as the eye can see, and those assumptions are much too optimistic.

So given current circumstances, the job and growth package in particular and the budget in general are somewhere between disappointing and cynical documents. They would do little to address current economic problems. They would make long-term economic problems worse. At a time of impending war, they would provide windfall gains to the wealthiest citizens but impose stringent conditions on those who are least able to make sacrifices. I don't think I would describe that as compassionate public policy, nor would I describe it as wise or effective public policy. Thank you.

[The prepared statement of Mr. Gale follows:]

Statement of William G. Gale, Co-Director, Tax Policy Center, Brookings Institution

Chairman Thomas, Ranking Member Rangel, and Members of the Committee:

Thank you for inviting me to testify today. It is an honor to appear before this committee. President Bush and members of Congress have proposed several new tax-based incentives aimed to raise economic growth. My testimony is divided into two sections: a summary of the conclusions, and supporting analysis.

Summary of major conclusions

- In considering policies to spur the economy, it is important to distinguish short-term and long-term problems. In the short-term, the major economic problem is inadequate aggregate demand, as evidenced in particular by low rates of utilization of capital among businesses. The key to boosting the economy in the short-run is boosting demand in order to fully utilize existing capacity. In constast, in the long-term, economic growth depends on the extent to which productive capacity (including physical capital, human capital, and economic institutions) is able to grow. Sustained increases in such capacity require increases in national saving.
- Tax cuts have ambiguous effects on economic growth in the long run. Tax cuts can affect economic growth in the long run through at least two channels. First, a tax cut will affect labor supply, human capital accumulation, saving, investment, entrepreneurship and so on. Second, the reduction in revenues will raise the federal deficit (unless matched by spending reductions) and hence reduce national saving. The net effect on growth is the sum of the (generally positive) effects created by more favorable economic incentives and the (negative) effects created by the increase in the deficit. For the tax cut to have a net positive effect on growth, the effects on labor supply, saving, etc., not only must be positive, they must be larger than the drag created by the increased deficit. Increased deficits reduce national saving and future national income regardless of whether deficits raise interest rates. One of the best ways to encourage economic growth is to keep national saving high, which in turn implies that public saving should be high.
- The 2001 tax cut was poorly designed to raise growth. According to Treasury data, 64 percent of taxpayers will receive no reduction in marginal tax rates. But the tax cut will reduce revenues by $1.7 trillion through 2010 and reduce national saving. Estimates of how deficits affect interest rates used by President Bush's Council of Economic Advisers imply that EGTRRA will raise the cost of capital for most investments. Researchers have generally found that the positive effects of the 2001 tax cut on labor supply, saving, etc., are likely to be offset by, and may well be outweighed by, the negative effects of the tax cut in reducing national saving.
- For the same reasons, accelerating the 2001 tax cut and/or making it permanent is unlikely to stimulate growth. An acceleration could raise the cost of capital on new investment for small businesses because it reduces the tax rate against which investment deductions may be taken. Likewise, making the 2001 tax cut permanent is neither affordable, nor would it do anything to spur growth currently. Given that EGTRRA as a whole probably had either a negligible or negative impact on growth, making it permanent is not a pro-growth strategy.
- The President's proposal to reduce taxes on dividends and capital gains is unlikely to generate much in the way of new growth. By reducing the double taxation of dividend income, the plan could reduce the cost of new corporate investments financed by new equity issues. It would not reduce the cost of investments financed by debt, and would likely reduce investment in non-corporate sectors, including housing and small businesses. It would also raise interest rates by encouraging investors to move from bonds to stocks. By raising deficits, it would reduce future national income. A study of all of these effects by Macroeconomic Advisers finds that plan would have no effect on average GDP between 2003 and 2007, would raise interest rates, and in the long run would *reduce* productivity.
- Increasing the temporary provision for partial expensing from its current 30-percent level is unlikely to spur much new investment. The primary problem that businesses face currently is inadequate demand and economic uncertainty, as evidenced by low capacity utilization rates. It is unclear why businesses would want to invest more, given that demand is so low they do not even use the capital they currently have.
- Small businesses would not generally fare well under the proposals under consideration. They would be helped directly by the proposed increase in expensing limits. But the acceleration of the tax cut, the dividend proposal, and the expansion of partial expensing would raise the cost of new investments and reduce the funds available for new investments by small business.

Supporting text

1. Description of proposals

The President's budget contains four major tax-related proposals aimed at increasing economic growth. It would accelerate to January 1, 2003, some, but not all, of the income tax cut provisions that were enacted in 2001 and scheduled to be implemented in the future. It would make EGTRRA permanent. It would exclude all corporate dividends from taxation under the individual income tax provided that corporate taxes have been paid on the earnings generating the dividends. A related provision would allow companies to deem dividends without actually paying them, thus reducing eventual capital gains and capital gains taxes for shareholder. It would increase the small business expensing limits to $75,000 from $25,000, and index for inflation. Another proposal that has been floated is to increase the 30 percent partial expensing for corporate investments (which was enacted in 2002 and applies to investments made between September 11, 2001 and September 2004) to either 40 percent or 50 percent.

2. Relations between tax cuts, deficits, and economic growth

National saving is the sum of private saving (which occurs when the private sector spends less than its after-tax income) and public saving (which occurs when the public sector runs budget surpluses). National saving is identically equal to—and is used to finance—the sum of domestic investment and net foreign investment. Domestic investment is the accumulation by Americans of private assets at home, or of public (government) assets. Net foreign investment is the nation's investment overseas minus borrowing from abroad (foreign investment in the United States). An increase in net foreign investment may take the form of increased U.S. investment overseas, increased U.S. lending to foreigners, reduced foreign investment in the United States, or reduced U.S. borrowing from abroad. The composition of the change in net foreign investment is of secondary importance, and we will typically refer to an increase in net foreign investment as "increased borrowing from abroad." We refer to the sum of domestic and net foreign investment as "national investment."

In simplest terms, national saving must by identity equal national investment, and an increase in national saving must show up as an increase in domestic investment and/or net foreign investment. Either way, the accumulation of assets due to increased saving and investment means that the capital stock owned by Americans is increased. The returns to that additional capital—whether domestic or foreign—raise the income of Americans in the future.

These macroeconomic building blocks highlight two key points: An increase in the budget deficit (a decline in public saving) reduces national saving unless it is fully offset by an increase in private saving, and a reduction in national saving must correspond to a reduction in national investment and in future national income, holding other things equal.

Barro (1974) demonstrates that if households are fully rational and take the well-being of their descendants into account in formulating their consumption and savings patterns, reductions in taxes today would be balanced by offsetting increases in private saving today. In particular, households would recognize that the reduction in taxes today would increase future tax liabilities and thus save the tax cut. Numerous tests of household saving behavior, however, conclude that households do not follow the dictates of this model (Bernheim 1987). The implication is that increased budget deficits are not fully offset by increases in private saving, and therefore result in a reduction in national saving.

A decline in national saving must reduce private domestic investment, net foreign investment, or some combination thereof. The reduction in investment reduces the capital stock owned by Americans, and therefore reduces the flow of future capital income. Either the domestic capital stock is reduced (if the reduction in national saving crowds out private domestic investment) or the nation is forced to mortgage its future capital income by borrowing from abroad (if the reduction in national saving generates a decline in net foreign investment). In either case, future national income is lower than it otherwise would have been.

3. Changing EGTRRA

A. EGTRRA and Growth—The analysis above considers only the effects of reduced budget surpluses or increased budget deficits *per se.* It establishes the crucial observation that, other things equal, smaller budget surpluses reduce future national income relative to what it would otherwise be, and do so regardless of how they affect interest rates. In this section, we point out that a full analysis of policies that raise

deficits or reduce surpluses needs to take into account (1) the direct effects of the policy in question, ignoring any change in the deficit, and (2) the change in the deficit.

The most recent prominent example of this issue is the 2001 tax cut. The net effect of the 2001 tax cut on growth is the sum of its direct effect on changes in incentives and after-tax income and its indirect effect through changes in the budget deficits. The improved economic incentives from provisions of the 2001 tax cut, analyzed in isolation, tend to raise labor supply, human capital accumulation, and private saving. But these changes in incentives are financed by reductions in public saving. Thus, to gauge the full effect on growth, one needs to factor in the effect of lower public saving on economic growth.

Given the structure of the 2001 tax cut, researchers have generally found that the positive effects on future output from the impact of reduced marginal tax rates on labor supply, human capital accumulation, private saving and investment either substantially offset or even outweigh the negative effects of the tax cuts via reduced public and national saving (see Auerbach 2002, CBO 2001, Elmendorf and Reifschneider 2002, Gale and Potter 2002).

There are several factors that help show why the effects of EGTRRA on growth are likely to be small or even negative. First, Treasury data in Kiefer et al (2002) show that 64 percent of tax filers with positive tax liability, accounting for 38 percent of all taxable income, would receive *no reduction* in marginal tax rates under EGTRRA. Most of these households were either in the 15 percent bracket or on the alternative minimum tax. Second, the increase in the deficit could raise interest rates and that increase would raise the cost of capital on new investments. President Bush's Council of Economic Advisers routinely uses an estimate that a $200 billion increase in the deficit raises interest rates by 3–5 basis points. If so, the $1.7 trillion cost of EGTRRA over the next 10 years would be expected to raise interest rates by between 25 and 42 basis points. Gale and Potter (2002) show that if EGTRRA causes interest rates to rise by 30 basis points, then the net effect of EGTRRA—including reduced marginal income tax rates—is to raise the cost of new investments for sole proprietors, for housing, and for corporate investments in structures. Only the cost of corporate investments in equipment would fall, and by less than 1 percent. Third, the reduction in federal surpluses (or increases in deficits) of $1.7 trillion through 2011 will reduce national saving. The $1.7 trillion includes $1.35 trillion in tax cuts plus the additional debt service costs.

B. Accelerating EGTRRA—All of the reasons noted above, combined with the fact that accelerating EGTRRA is a *temporary* tax cut, suggest that accelerating the 2001 tax cut would have negligible effects on growth. In fact, at least one aspect of accelerating the tax cut could *reduce* investment currently. The cost of capital that sole proprietors, partnerships, and S-corporations face on new investment depends in part on the present value of the depreciation allowances they are able to deduct. Thus, a business would like to deduct depreciation against high tax rates, since a $1 dollar deduction is worth more the higher the tax rate is. Right now, with tax rates poised to decline over time, businesses (other than C Corporations) face the rosy prospect of making investments now, taking the deprecation in the next few years at relatively high tax rates and then reporting the income in the future after 2006 against relatively low rates. Reducing tax rates now would reduce the benefit of the depreciation deductions and hence could reduce new investment by those businesses.

C. Making EGTRRA Permanent—Making EGTRRA permanent is unlikely to stimulate growth, for the same reasons that EGTRRA is estimated to have little impact on growth over the next decade. Still it is worth noting that the Congressional Budget Office (2003) has estimated that letting EGTRRA sunset would reduce GDP by 0.5 percent. Perhaps surprisingly, this estimate is fully consistent with EGTRRA having little or no impact on economic growth over the past decade and little or no impact in the future.

To see this, recall that taxes have two sets of effects—one on incentives and one on national saving via the deficit. The CBO estimate of the effects of letting EGTRRA expire is solely an "incentive" effect. Note that it implies that the cumulative value of the incentives in EGTRRA would be to raise GDP by 0.5 percent over the decade. That implies an increase in GDP of about $81 billion by 2011 (CBO 2003, table 1–2). But recall also that the full effects of EGTRRA are the incentive effects plus the impact on national saving. To calculate the latter effect, note that EGTRRA reduces budget surpluses by $1.7 trillion over the decade. Assuming that private saving rises by about one-third of this amount (based on Gale and Potter 2002), national saving falls by $1.13 trillion. With a 6 percent interest rate, the decline in national saving implies a reduction of $68 billion in income. That means

that EGTRRA will raise GDP by only $13 billion (81–68) in 2011. This is less than 0.1 percent of GDP.

4. The dividend proposal

A. As corporate tax reform—The dividend tax proposal is intended to tax corporate income once and only once. Three points are important to emphasize about this proposal. First, most corporate income in the United States is not taxed twice. A substantial share of corporate income is not taxed at the corporate level, due to shelters, corporate tax subsidies and other factors (McIntyre 2003). Recent evidence suggests growing use of corporate tax shelters (Desai 2002). Furthermore, half or more of dividends are effectively untaxed at the individual level because they flow to pension funds, 401(k) plans, and non-profits (Gale 2002). Although data limitations make definitive judgments difficult, the component of corporate income that is not taxed (or is preferentially taxed) appears to be at least as large as the component that is subject to double taxation. That is, the non-taxation or preferred taxation of corporate income is arguably at least as big of a concern as double taxation.

Second, the Administration's proposal would have no effect on firms' incentives to shelter and retain earnings to the extent that firms are owned by non-taxable shareholders. To the extent that firms are held by taxable shareholders, the Administration proposal would reduce incentives to shelter somewhat, but firms would still maximize shareholders' after-tax returns by sheltering corporate income from taxation and then retaining the earnings—the same strategy that maximizes taxable shareholders' after-tax returns under current law. Despite the Administration's claims to the contrary, the proposal therefore does not eliminate, and may not even reduce to a significant degree, the incentives that exist under the current tax system to shelter corporate income from taxation and then to retain the earnings.

Third, the Administration's proposal may result in a variety of new tax shelters.

A partial dividend exclusion is not a solution to these problems either. It just reduces both the benefits and costs of the proposal. Proponents of the dividend exclusion often note that many European countries have partially or fully integrated their corporate and personal tax systems. However, it is also the case that several European countries have recently moved away from integrated systems (Avi-Yonah 2003). In addition, the large share of corporate equities are held by shareholders that are not subject to individual dividend and capital gains taxes appears to be much higher in the United States than in most European countries.

The bottom line is that the Administration's proposal does the "easy" part of tax reform: it cuts taxes. It fails, however, to do the difficult part of any serious tax reform effort: broadening the tax base and eliminating the share of corporate income that is never taxed (or taxed at preferential rates). That difference is what distinguishes "tax reform" from "tax cuts." The approach proposed by the Administration would also undermine the political viability of true corporate tax reform. Any such reform would have to combine the "carrot" of addressing the double taxation of dividends with the "stick" of closing corporate loopholes and preferential tax provisions, but the Administration's proposal simply gives the carrot away. Burman (2003) and Gale and Orszag (2003) discuss modifications to the Administration's proposal that would represent a more balanced approach to changing the system of taxing corporate income.

B. As a Growth Package—In the long run, the key to economic growth is to expand the capacity of the nation to produce goods and services. That capacity, in turn, depends on national saving. Yet the Administration's plan will expand the budget deficit, which will have the effect of *reducing* national saving. Only if the economic benefits of the policy changes generating the deficits *more than offset* the losses imposed by reduced national saving would the net effect be positive.

A study by Macroeconomic Advisers (2003) reached the following conclusions regarding the growth and jobs package, including the dividend plan: The plan would have no effect on average GDP between 2003 and 2007. Employment would grow by an average of 21,000 per year over the next five years. The yield on 10-year Treasury notes would rise by 23 basis points by 2004 and by about 50 basis points by 2007. In the long-term, productivity would *fall* and the cost of capital would *rise*, due to the effects of increased deficits on national saving and interest rates.

It is worth emphasizing several reasons why the plan may not stimulate much if any growth. First, although the plan will help allocate an existing amount of investment more efficiently across sectors (though significant corporate tax reforms would do an even better job in this regard), by raising the deficit and reducing national saving the plan is likely to reduce the total amount of capital owned by Americans. Second, the impact on corporate investment will be muted to the extent that interest rates rise (due to making equities more attractive) and the extent to which investments tend to be financed with debt or retained earnings. Third, to the extent

the proposal would attract funds to the corporate sector, those funds may simply generate one-time windfall gains in corporate stock without affecting investment. Any increase in stock values would raise consumption somewhat and would serve to reduce private saving. Fourth, to the extent that funds are channeled to the corporate sector, fewer funds may be available to finance investment by unincorporated business and S-corporations. To the extent that interest rates rise, investment in interest-sensitive sectors like housing may decline.

5. Increase in partial expensing

Expanding the partial expensing provision is unlikely to generate much in the way of new investment. Although there is an established research finding that, on average, cuts in the cost of capital raise investment, there is—to my knowledge—no evidence that demonstrates that such policies work well *in the presence of substantial non-utilization of existing capacity.* That is, the key question is not whether such incentives work well under average conditions, but whether they work well under acute conditions—with low investment and low capacity utilization.

Intuition suggests that under current circumstances firms are not likely to be very responsive to changes in investment subsidies. For example, despite generous subsidies to new investment embodied in the 2002 stimulus act (including the provision to allow 30 percent partial expensing in the first year), and despite low inflation (which reduces the cost of investing because it raises the value of nominal depreciation allowances in the future) and low interest rates, investment has remained constant or fallen over the last few years. If an increase from zero to 30 percent partial expensing had such a small effect on investment, it is hard to see how increasing it more would cause an investment surge.

6. Effects on small business

A key concern for policy makers is the impact of the tax cut plans on small businesses. The proposals in question would have a variety of effects on the small business sector and it is not at all clear that the sector would come out ahead (Lee 2003).

- Under the President's growth and jobs more than half (51.6 percent) of tax returns with small business income would receive a direct tax cut of $500 or less in 2003.
- The expansion of small business expensing options will undoubtedly reduce the cost of capital for some small businesses and encourage them to invest more. Note, however, that this occurs only in a limited range of investment and the subsidies are taken back when investments reach a higher level.
- Lower marginal tax rates will improve cash flow and reduce taxation of income from old projects for some businesses but as noted above it will raise the cost of capital for new investments and thus may reduce new investments.
- The dividend proposal would divert capital from the small business sector and put upward pressure on interest rates, both of which would increase the cost of capital for small businesses and may reduce new investments by that sector.
- A recent study by Cullen and Gordon (2002) find that EGTRRA will reduce the level of entreprenuerial activity by reducing the tax benefits of entrepreneurship relative to other economic activity. Accelerating the tax cut or making it permanent may therefore be unlikely to help the small business sector as a whole. Cullen and Gordon (2002) argue that—and present evidence that—incentives to engage in entrepreneurial activity fall when individual income tax rates fall because small businesses can shelter income more effectively than wage earners can. Also, lower tax rates make risky projects relatively less attractive because the government bears less of the risk. Moreover, when personal tax rates are high, entrepreneurs have the advantage of being able to take losses at high personal tax rates, but if projects succeed they can incorporate and reduce their tax rate.

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Much of this testimony is based on collaborative work with Peter Orszag. All errors and opinions are my own and should not be taken to represent the views of the Brookings Institution or the Tax Policy Center.

Chairman THOMAS. Thank you very much. In attempting to artificially divide the President's package primarily in terms of the individual rates and the associated tax changes, such as the so-called marriage penalty and the child credit, from the dividend, I see we were not as successful as we had hoped to be because if we tell you to stay at the shallow end of the pool, you are going to swim to the deep end, anyway.

I would like to ask some questions focused on the fact that all three of you were able to offer testimony in which, if my ear was working, I never heard the term "stimulus." I heard "immediate boost," "jump-start," and a few more euphemisms.

If the question were asked—and I think the President was correct in identifying his package overall not as a stimulus but, as he calls it, "a jobs and growth package," if you were to look for those areas that could carry the old-fashioned label "stimulus," would you find any? If it was an area where you would expect to find it, is it large enough to justify the term "stimulus"? If it isn't, how big would it need to be? Mr. Glassman or Mr. Castellani or Mr. Gale?

Mr. GLASSMAN. I don't think that this is a stimulus package. I think it is a growth package. I am glad that it is not a stimulus package because I think "stimulus" has connotations of kind of artificiality, sort of like a joy buzzer or something. I think that it will—stimulus tends to have negative effects on the back end. So I am happy this isn't.

There are stimulating elements, certainly. The fact that investors will receive more current income as a result of dividends, the fact that they will be able to keep more of their own earnings as the rate cuts are accelerated, the fact that the child credit will directly put dollars in the pockets of parents with children—these will all have stimulative effects as long as people make the decision to spend that money rather than to save it. There will be stimulative effects. I just don't think that the major thrust of this—and I am glad it isn't—is quick fix, because I don't think that is what we need.

Chairman THOMAS. When you are dealing with a more than $10 trillion a year economy, if you really want to stimulate, it takes more than a trickle charge, and the dollar volumes here I think we are looking at probably don't meet that level either.

Mr. GLASSMAN. No.

Chairman THOMAS. Is that what you are saying?

Mr. GLASSMAN. Absolutely, Mr. Chairman. As I say in my testimony, I think it is important to note that these are—the President's proposals are modest. In other words, they are—if you look at them from a static point of view, that is to say, if you think they will have no beneficial economic effect at all, that people will just take the extra money and flush it down the toilet, it represents about a little bit less than $700 billion, which is one-half of 1 percent of the total output of the economy over that period.

Chairman THOMAS. Thank you.

Mr. CASTELLANI. Mr. Chairman, I would take some issue with what my friend Jim just said, and that is, one of the things that is attractive about all of the elements in combination of this package is that it does provide both a short-term boost to the economy as well as an incentive for long-term growth.

In the Business Roundtable view, both are needed. We have been concerned that the economy is growing well below its potential. We believe it can grow at rates in excess of 4 percent without any fear of inflation, and it is growing below a rate where we can see substantial increases in jobs.

Our analysis, which we have submitted with our testimony, shows that, in fact, all three elements—the rate acceleration, the acceleration of the credits, and the elimination of the dividend double taxation—contribute both in the short term and the long term. We see a substantial impact, if enacted by the middle of this year, to the economy in growth by the end of next year and see a substantial impact in job creation. So it is both in the short term and sustained over the 8 to 10 years that we have looked at it that it has benefits, and we believe both are necessary.

Chairman THOMAS. Again, the term "stimulus" was not used. If you would take the analogy of a battery in the economy, you can either trickle charge it or you can jump-start it. I think the stimulus tends to be in the jump-start category, and you believe there are components that tend to lean toward the jump-start analogy rather than the trickle charge.

Mr. CASTELLANI. We do. More importantly, we believe that is necessary.

Chairman THOMAS. Is it enough, if you believe it is necessary? Or would you like more?

Mr. CASTELLANI. In our deliberations, we felt that a package that could be in its first 2 or 3 years about in the $200 to $300 billion range would be sufficient to change behavior, and that is what this package and what H.R. 2 achieves.

Chairman THOMAS. Thank you very much. Mr. Gale?

Mr. GALE. Thanks. This is not a stimulus, for two reasons. One is that the tax cuts being proposed in the budget are gigantic. If they were all enacted, they would be about 2.5 percent of GDP by the end of the decade. Looking forward, that would be enough—that amount of money would be enough to solve both the Social Security and the Medicare part A financing problem over the next 75 years. So there are very large tax cuts being talked about. A very tiny fraction of those tax cuts that are being presented would take effect in this year and next year. So the proportion of the bill that is stimulus is minuscule.

The second reason it is not stimulus is the structure of the tax cut itself. The idea that you are going to cut taxes permanently to boost the stock market on a one-time basis now and then you get some spending boost out of that, if you do the numbers, you get a spending boost of about $20 billion, assuming the stock market goes up 5 percent. In exchange for that, you are enacting a permanent tax cut that costs a lot in the out-years. So it is not well designed to generate stimulus.

If you wanted to stimulate the economy now, you would do two things. One is you would get the money in the pockets of low- and middle-income households who are more likely to spend it. The Administration's proposal specifically doesn't do that. The two features of the income tax cuts in EGTRRA that it did not accelerate are: one, the refundability of the child credit; and, two, marriage penalty relief for low-income households. If you were concerned

about stimulus or concerned about low-income households, you would accelerate those two items.

The other thing that you can do, which is the single best thing to stimulate the economy now, is Federal aid for the States. We have been through this discussion many times, but the basic point is the States, in order to balance their budgets, are cutting spending and raising taxes. Both of those things hurt the economy right now, and any Federal aid to the States would directly offset that on a one-to-one basis. One-to-one is a far better ratio than you would get through any of these other stimulus ideas.

Chairman THOMAS. Thank you. Would you find the child credit more attractive if it were refundable?

Mr. GALE. If it were refundable, the money would be going lower in the income distribution than it currently is, and econometric evidence suggests that the likelihood of that money being spent is much higher than money that goes to people in the upper part of the income.

Chairman THOMAS. So irrespective of whether you support the provision or not, making it refundable makes it more attractive to you.

Mr. GALE. It makes it more of a stimulus.

Chairman THOMAS. Yes. Okay. Thank you very much. Does the gentleman from New York wish to inquire?

Mr. RANGEL. Thank you. Mr. Glassman and Mr. Castellani, would your support of the President's package be just as strong if you knew hypothetically as a fact that we were going to war in Iraq?

Mr. CASTELLANI. Absolutely. We think that economic security——

Mr. RANGEL. That is good. That is good.

Mr. CASTELLANI. Plus, national security are tied.

Mr. RANGEL. Mr. Glassman.

Mr. GLASSMAN. Yes, sir.

Mr. RANGEL. Would you say that if it was a short war, we went in there, got it done, and got out fast that it could actually be a stimulus to our economy?

Mr. GLASSMAN. I am sorry. The war itself would be a stimulus?

Mr. RANGEL. That is what I asked.

Mr. GLASSMAN. No, I don't think war is ever a stimulus to an economy except in the sense that it changes an environment——

Mr. RANGEL. Mr. Castellani, do you think it would spur the economy at all?

Mr. CASTELLANI. No.

Mr. RANGEL. Do you think lower gas prices would have any impact on our economy, either one of you or both of you, if prices of oil were to drop? Do you think that might stimulate the economy at all?

Mr. GLASSMAN. Yes.

Mr. CASTELLANI. Yes.

Mr. RANGEL. Do you think that if we went there, seized the oil fields, and managed to control or increase production, that would have any impact on the Organization of Petroleum Exporting Countries (OPEC) in terms of the price of oil in that area?

Mr. GLASSMAN. I don't know whether it would have an effect on OPEC, but it would certainly increase supply a little bit at the margin and——

Mr. RANGEL. No, no. I am asking——

Mr. GLASSMAN. It would lower prices.

Mr. RANGEL. You don't think that it would not—if we were able to control the production of oil in Iraq, you don't believe that would have any impact on the price of oil as it relates to OPEC?

Mr. GLASSMAN. I think it would—technically—I don't know about OPEC, but it would certainly have——

Mr. RANGEL. I am only talking about OPEC. I am not talking about anything else. I am talking about——

Mr. GLASSMAN. The price of oil——

Mr. RANGEL. The inability of OPEC to control the supply of oil if we were in control of the production.

Mr. GLASSMAN. A little bit.

Mr. RANGEL. Okay. How about you, Mr. Castellani?

Mr. CASTELLANI. Well, you know, this is not an area that we have examined, but I would say that if the United States were controlling the production of oil in Iraq, it would have other political implications within the OPEC nations that might offset any advantage.

Mr. RANGEL. Okay. Neither one of you have any idea, nor do we, whether we are going to war or not. Among all you people involved with business, if there was something that could have the cost implied that we would have with this war, the $100 billion—we now get an estimate from the Administration that occupation could be $100 billion a year. Secretary Rumsfeld said it may take 4 weeks, 4 months, 4 years. You know, while we didn't hear the word "stimulus," we didn't hear the word "war," if there is a war. Does that have anything to do with whatever we are talking about today if it is a long-term war, in your opinion?

Mr. GLASSMAN. Well, I think it does in the sense that if we have a long war, or if we have a war, period, I think it is important that——

Mr. RANGEL. That is good. That is good.

Mr. GLASSMAN. The economy——

Mr. RANGEL. No, no, no. I just want to know——

Mr. GLASSMAN. Remain sound.

Mr. RANGEL. Whether it is a factor. The only reason I am—this man is rough on the time when he is not talking. So I just want to prepare for the next question. Do you think that a long-term war, Mr. Castellani, could have any impact on the budgetary situation that our great Nation finds itself in?

Mr. CASTELLANI. I think the potential for the war right now is having a significant impact on the economy, both the war with Iraq, potentially, and the war on terrorism. Obviously war has its cost, but that does not mean, in our view, that we should forego opportunities to have a vibrant economy, too.

Mr. RANGEL. I am just saying, wouldn't you want to know what the cost of the war is going to be? I understand the President said yesterday that if the diplomatic initiatives fail in North Korea, we are prepared to go militarily. We are in the Philippines. We are in

Colombia. We are going to have to get more troops and all of these things.

I am asking you, Mr. Castellani, as a businessman, should we consider or factor in the possibilities of the cost of this extended war as we look at this present budget before us? Just between you and me, the Administration has no figures to give us about a potential cost of the war. They haven't the slightest clue. They said to do that would be declaring war. Since you are not part of the Administration and you are nonpartisan, you could give us a professional view of this without saying that you are declaring war.

It is a hypothetical. If we were involved in a long-term war and we had to fight more than one war at a time, like the President may do in North Korea, and if we have to send more troops to the Philippines and to Colombia, and we have an expanded search for Osama bin Laden, wherever he is, do you think that would be a factor in the budget that is before us today?

Mr. CASTELLANI. Congressman, I have no idea—I have no way to calculate nor does the business community have a way to calculate the cost of the war or the scenarios under which it would be waged.

Mr. RANGEL. If a big hurricane—if you were in business and they told you a big hurricane was coming, you would have no way to know whether the hurricane was coming or not. If that is what the experts were telling you and you were preparing a budget, would you prepare for a hurricane which I am describing as a war?

Mr. CASTELLANI. Well, good risk management in business always prepares for as much of the uncertainties as we can identify and the costs that we can identify.

Mr. RANGEL. Well, I am saying that the Administration refuses to identify any cost. Thank you, Mr. Chairman.

Chairman THOMAS. Does the gentleman from Florida wish to inquire?

Mr. SHAW. Briefly. Mr. Glassman, what effect do you see that the threat of war has had on the markets at this particular point?

Mr. GLASSMAN. I am sorry, sir. On the stock market?

Mr. SHAW. How the threat of war, what effect has that had on the markets?

Mr. GLASSMAN. I think it has had a severe effect. The geopolitical situation, as Alan Greenspan calls it, has increased uncertainty as opposed to measurable risk. Everyone who goes in the stock market understands what the historic risks of investing are, or they should. There are uncertainties, like what we face today with Iraq and terrorism, that really scare investors. One of the responses that investors have is that they take their chips off the table. They basically say, "I am not playing." Not only do investors in the stock market say this, but also businesses themselves. That is the condition that we are in today.

When this situation clarifies itself, I think that will change. I would also say, in sort of late response to Mr. Rangel's question, that one-time expenses, even $100 billion—which, by the way, is less than 1 percent of this country's GDP—have far less effect on the overall structural economy than things that go on and on and on. Just like hurricanes. We can absorb that in this economy, and

I think we need to look to the long term for economic growth and make these changes.

Mr. SHAW. Thank you. Mr. Gale, I may have misunderstood what you said, so correct me if I have. I think I heard you say that doing away with the double taxation of dividends would have a one-time stimulus effect. Did I understand you correctly to say that?

Mr. GALE. On the stock market I think is what I was referring to. That is, if you——

Mr. SHAW. Yes, now, don't you think that it would have a permanent effect of making stocks a more desirable investment?

Mr. GALE. That is what I meant. There would be a one-time ratcheting up in stock prices.

Mr. SHAW. That would be permanent.

Mr. GALE. Permanent, yes.

Mr. SHAW. Mr. Castellani, would you comment on that, please?

Mr. CASTELLANI. Yes. We think it has a number of benefits. First, of course, it puts more money in shareholders' hands and across the economy. More importantly, it is the gift that keeps on giving because it will change corporate behavior. That change is most manifested by the fact that it will increase payout ratios by corporations, which puts even more money into the economy and makes valuations of equities even more attractive because they have higher yields.

Mr. SHAW. By "the gift that keeps on giving," you take exception with what Mr. Gale just said.

Mr. CASTELLANI. Well, he said it would have a one-time impact, but it is not a one-time event because over the course of time, payout ratios will continue to increase to meet shareholder demands, quite frankly, and because the disparity between retained earnings and distributed earnings has been eliminated.

Mr. GALE. Could I try to clarify this?

Mr. SHAW. Please do.

Mr. GALE. Changing the dividend payout ratio doesn't change at all the amount of money that is in the economy. It just changes the amount that is in the firm versus the amount that the shareholder has in their pocket. Whether it is a good or bad thing is different, but changing the dividend payout ratio doesn't alter the size of the economy.

Mr. SHAW. Listen to your own testimony, because your message to us is that to put the money in the hands of the consumer was the best place to put it.

Mr. GALE. I think I said that if you wanted to stimulate the economy in the short run, you would get a bigger stimulus by putting money in consumers' hands than putting it through the stock market. That is correct.

Mr. SHAW. This is a long-term—putting more and more money into the hands of the consumers.

Mr. GALE. That doesn't change anything about the fact that you would get a permanent ratcheting up in the stock market.

Mr. SHAW. Also, I think it is important—I think it is also important to realize that by making the stock market a more desirable place to invest, that stimulates the investment in capital.

Mr. GALE. Well, there is an issue there because the bigger the initial stock market effect, the smaller the ultimate investment effect. The bigger the stock market effect, the more of the benefit is a windfall gain to existing investors. The reason I say it is a windfall gain is because when they bought their stock, they bought it knowing that there was double taxation, and, therefore, they paid a lower price than they otherwise would have.

So when you remove double taxation on existing stock, you give them a windfall gain. That windfall gain doesn't do anything to stimulate new investment. The right way to integrate the corporate and individual tax is moving forward by cutting the tax on new investment. Cutting the tax on old investment doesn't do anything for economic growth.

Mr. SHAW. One follow-up, if I may, Mr. Chairman. That ratcheting up in the price of the stock will also develop into more revenue into the Federal Government, which will in itself reduce the proposed deficit or the revenue shortfall caused by the elimination of the double taxation.

Mr. GALE. I think that is included in JCT's estimates.

Mr. SHAW. Thank you, Mr. Chairman.

Chairman THOMAS. The gentleman's time has expired. Does the gentleman from California, Mr. Stark, wish to inquire?

Mr. STARK. Thank you, Mr. Chairman. Mr. Gale, the President and the Administration are fond of saying that we are going to have 92 million Americans who are going to get 1,083 bucks, on average. Yet Brookings, which I am sure you are familiar with, and the Urban Institute show that almost half of all the taxpayers would see their taxes drop by less than $100. Meanwhile, the tax savings for the 1 percent with the highest income would be around $24,000.

Wouldn't using the $100 be a more truthful estimate of the typical tax cut that would come out of this new plan?

Mr. GALE. Definitely. For all filers, the typical tax cut is $100. For all taxpayers——

Mr. STARK. Now let me go on another step, because this is where I am having trouble making this all—Mr. Castellani, I think it was in your testimony that you think that—while you say there are 1.5 million fewer people employed today than there were 2 years ago—when, by the way, we tried a tax cut and that didn't do any good, did it? The 2001 tax cut didn't create any jobs, did it?

Mr. CASTELLANI. Well, I would say our view is the 2001 tax cut did have a significant benefit——

Mr. STARK. So you think there would have been even more people out of work if we hadn't cut those taxes?

Mr. CASTELLANI. Particularly mitigating the impact of the terrorist attacks.

Mr. STARK. So we cut and cut and cut, and we certainly have—why, we could cut ourselves right into a boom time. You say that there are 1.5 million fewer employed, and I believe you would all agree, I think, that there is somewhere around a million people today who lost their unemployment benefits right after Christmas, on December 28th. This Administration is the only one of the three

most recent Republican Administrations that has not extended unemployment benefits for either 33 or 36 weeks.

Now, they say instead that they are going to go out and train people. I don't know what they are going to train them for, these unemployed people. First of all, they had to have a job to get unemployment, so they were doing something before they got laid off or the company went broke or whatever. It is a mystery to me what they are going to train them to do. Are they going to train plumbers to be chiropractors and—I don't know what. These people arguably don't need training. They were working. They just don't have a job. You have all talked about getting some money into the economy, stimulus.

So for a measly 4 or 5 billion bucks, we could extend—and, by the way, that is in the unemployment trust fund. We could extend these unemployment benefits for a million people. That means they could pay their rent and buy food and buy shoes for their kids and do all the things that they are unable to do now, and arguably that money would come right back into the consumption stream of this country.

So it puzzles me why we should train people to do something when arguably it isn't the training, it is that there aren't any jobs. So why not in the interim, if you wanted to get some money to stimulate the economy, you wanted to help some people who aren't welfare cheats, they are not terrorists, they are just people who, through no fault of their own, are out of work. Why wouldn't it, Mr. Gale, be far more efficient with the taxpayers' dollars, which wouldn't take much, to extend these unemployment benefits to these million people?

Mr. GALE. If the goal is to stimulate the economy in the short run, that is another option that would have a much bigger bang for the buck.

Mr. STARK. How about just being compassionate to people who are down on their luck?

Mr. GALE. I would buy that one, too. In any case, it would give you a much bigger stimulus impact per dollar spent, studies suggest, than would accelerating the upper-income tax rates, for example.

Mr. STARK. Mr. Castellani, why wouldn't your membership buy into this? It isn't going to cost them anything.

Mr. CASTELLANI. Congressman, the real tragedy of this economy are the people who have lost their jobs, and that is precisely why we have been looking for and have been advocating, a growth package that will help us create jobs.

Mr. STARK. While you are looking around for that, what is wrong with the idea of doing what President Reagan did and the previous President Bush did and let these people have some decent standard of living and stimulate the economy for another 33 weeks?

Mr. CASTELLANI. We think that it is absolutely—and as the Congress has done—necessary to extend the unemployment benefits for the people who have been laid off. We think it is much more important to create jobs so that they can come back into the workforce and help stimulate——

Mr. STARK. I am with you. Would you send the message back? It wouldn't cost much, it would be humane, it would keep people from sitting on the street with tin cups, and they would be there when your factories start up again. We would have those people in the neighborhood ready to go back to work. Thank you.

Chairman THOMAS. The gentleman's time has expired. Does the gentleman from Illinois, Mr. Crane, wish to inquire?

Mr. CRANE. Thank you, Mr. Chairman. To all of you, in addition to increasing the amount that a small business can expense, the proposal also increases the number of companies eligible for the provision. Treasury Secretary Snow told us yesterday that an estimated 23 million small businesses will be eligible for Section 179 expensing if this proposal is enacted.

Can you comment on how this will affect the economy in the short term? Starting with you, Mr. Glassman.

Mr. GLASSMAN. Thank you, Congressman. Well, I think this is an excellent idea. It will directly encourage small businesses to make the kinds of investments that they haven't been making right now. They don't have that added incentive to do so, and, frankly, I would like to see this same program extended beyond small business. We just need more investment in this country. That is really our major advantage over other nations, so I think it is a very good idea.

Mr. CRANE. Mr. Castellani?

Mr. CASTELLANI. Congressman, the Business Roundtable members are a lot of things, but small business is not one of them. We, of course, and our members would not benefit from this, but we do believe it would be helpful, and helpful for small business that does generate many of the jobs in this country, and we would encourage it and support it.

Mr. CRANE. Mr. Gale?

Mr. GALE. This bill is a Faustian bargain for small businesses. It is true that they get the increase in expensing, but I think it is also worth pointing out that that is only about 1 percent of the total tax cut.

Under the President's bill, more than half of tax returns with small business income would get a tax cut of less than $500. That is one issue. A second issue is that, as I mentioned before, the dividend proposal would divert capital from the small business sector, unambiguously, and put upward pressure on interest rates, both of which would increase the cost of capital for small businesses and could reduce new investments in that sector.

So if I were a small businessman, I would think twice before I enthusiastically signed on to this package.

Mr. CRANE. Even though you were getting relief.

Mr. GALE. Well, you are getting the direct relief, but remember, a lot of businesses are not getting very much relief. More than half are getting $500 or less. You are getting indirect expense via the fact that there is going to be less financing available for the small business sector, and that which is available is going to be more expensive. So they would have to weigh whether their particular tax cut is big enough to outweigh the costs of less available credit and more expensive available credit.

Mr. CRANE. Can I put a general question out to all of you again? That is, do businesses pay taxes? Or is that not just a cost of doing business, like plant and equipment and labor, and you have got to absorb your costs and pass them on to the consumer and get a fair return on investment or you are out of business?

Mr. GALE. There is a distinction here between corporations and unincorporated businesses. In corporations, it is axiomatic among economists that businesses don't pay taxes, people do. That is, corporations either pass the tax along to their customers, their workers, their suppliers, or if none of the others, they pass it on to their shareholders.

In a small business, the owner is the shareholder, the worker, the manager, et cetera. So I think in a very real sense it is often the case that the owner of the small business would bear the burden of less credit and higher interest rates.

Mr. CRANE. For him to survive, he has got to pass that tax cost on to the consumer of whatever it is he is marketing. It is a form of stealth taxation.

Mr. GALE. If that were the case, then small business should have no complaints about taxes on their products.

Mr. CRANE. Why? Why shouldn't they have a complaint?

Mr. GALE. If it is just passed on to the consumers, then it doesn't make the small business any worse off.

Mr. CRANE. Yes, but not every one of them can pass it on.

Mr. GALE. Well, that is my point exactly. If they can't pass it on, they are bearing the burden. That is exactly my point.

Mr. CRANE. Absolutely. All right. Thank you.

Chairman THOMAS. The gentleman's time has expired. Does the gentleman from Michigan, Mr. Levin, wish to inquire?

Mr. LEVIN. Thank you, Mr. Chairman.

Just one brief comment, Dr. Gale, on your excellent testimony. You referred to deficits as far as the eye can see. I think that there are now deficits much further than the eye can see. This relates, unless you believe deficits don't matter, to interest rates, which affect small business.

Mr. Glassman, we were talking about Iraq and the impact on the stock market. As I remember it, the stock market began to go not up toward your 36,000 but down, before Iraq became an imminent—if it isn't that, a clear issue on the horizon. So our economic troubles began before Iraq was the predominant or dominant feature.

Mr. Castellani, let me just go back to you for a moment, because your testimony said that that is why last November the Roundtable urged the President and Congress—this is on page 2—to take immediate action on a large economic growth package aimed at consumers. So just quickly, in 30 seconds or so, tell me what parts of this package are directly aimed at consumers and what percentage of it.

Mr. CASTELLANI. Well, in fact, all of it is aimed at consumers. What we were saying in that point is that from our perspective, given the choices to stimulate economic growth, we didn't incentives to invest in more capacity. We have more than sufficient capacity in manufacturing and services across the economy to meet demand from American and worldwide consumers.

What we felt was necessary was to stimulate that consumption at a greater level than we are currently seeing and what we anticipate.

Mr. LEVIN. Okay. So, your proposal had some change in the payroll tax, right?

Mr. CASTELLANI. We initially proposed looking at a change in the payroll tax and accelerating the tax cuts and eliminating the double taxation.

Mr. LEVIN. The payroll tax proposal would have directly and substantially affected consumers, right?

Mr. CASTELLANI. Yes, it would.

Mr. LEVIN. That is not in this package, right?

Mr. CASTELLANI. It is not.

Mr. LEVIN. Let me just say a few words and ask Mr. Glassman about stockholders because your testimony very much emphasizes them. I just want to read some figures. I think we need to look at the facts here about stockholders. The data I have show that for those in the top 10-percentage bracket by income, other than retirement funds, 60 percent have stock directly, while for the middle 20, it is about 16 percent. Do you have any reason to challenge those figures?

Mr. GLASSMAN. About direct ownership of stocks?

Mr. LEVIN. Yes. Other than retirement funds, this is the direct ownership of stocks, and I will get to mutual funds in a minute. Do you have any reason to challenge those figures?

Mr. GLASSMAN. I actually don't know the figures. I know that many Americans own stock through mutual funds and many through individual shares, and they do both.

Mr. LEVIN. It is important as we look at the dividend issue to look at who owns stock outside of retirement funds that aren't going to benefit from it directly. There is a dramatic differential. Your testimony is just replete with the notion that America is just filled with people who own stock, the assumption is in a degree that they have a real important stake in what happens in terms of their decisions.

Mr. GLASSMAN. I think that is true, absolutely.

Mr. LEVIN. When you look at the figures, so much of this is in retirement funds that they don't have direct control over. I don't control my investments in my retirement funds, and in most cases, they don't either.

So if you look at the percentages, the percentiles, for example, those in the 25th to 50th bracket who own stock outside of retirement funds, less than 10 percent own stocks and quite a bit less than 10 percent have investment in mutual funds. Those probably overlap a great deal. So there is a huge differential between those who own stocks outside of retirement funds according to income, a huge differential. When we look at the impact of the dividend change, you have to look at those facts.

So, I am going to send these to you, and I would like you to challenge them.

Mr. GLASSMAN. Thank you. Let me just make two quick comments. First, when Americans own shares—or actually own mutual funds through 401(k) plans, defined contribution plans, they are—it depends on how you define "control," but they are in control of

that money. It is quite different from an old-fashioned defined benefit plan. They own those stocks. They own those mutual funds. That means something to them, number one.

Number two, as I said in my testimony, even people who own stocks in non-taxable accounts will benefit directly from this change in the dividend law because the income which the people who own the stocks in taxable accounts receive will go up. Therefore, shares become more valuable to those people. They bid up the price of the shares, and everyone who owns the shares, whether they own them in a taxable account or a non-taxable account, benefits.

Mr. LEVIN. That is your assumption and your prediction, and I think we need to be a bit skeptical about that.

Mr. GLASSMAN. I agree, but I think that——

Mr. LEVIN. About your predictions.

Mr. GLASSMAN. Mr. Gale would agree with that prediction. As he said, you would have a one-time increase in stock prices for everybody, not just taxable accounts but also for non-taxable accounts. I will look at your——

Chairman THOMAS. The gentleman's time has expired, but I wonder if Mr. Gale agrees with that.

Mr. GALE. There is an issue basically——

Chairman THOMAS. I won't limit you to Charlie's "yes" or "no."

Mr. GALE. Okay. Well, basically the answer is yes, I think there will be a general boost in the market. It will be different depending on whether firms pay dividends, how much they pay. Yes, generally there should be a boost in the market.

Chairman THOMAS. Does the gentleman from California, Mr. Herger, wish to inquire?

Mr. HERGER. Yes, thank you very much, Mr. Chairman. Mr. Glassman, could you tell me just in general, is the American public, i.e., small businesses, businesses, the public in general, are they being taxed at a low historic rate, about normal, high? Do you know offhand?

Mr. GLASSMAN. American businesses?

Mr. HERGER. Our public in general, yes, and small business and those that are creating jobs.

Mr. GLASSMAN. Well, I can give you one fact which is based on the work of some of my colleagues, including Kevin Hassett at the American Enterprise Institute, that corporate taxes, when you include the tax on dividends, are now higher in the United States than in any industrialized country other than Japan. As for the rates for small businesses, if they are unincorporated small businesses, they are paying generally at the top individual ordinary rate, which is now 38.6 percent, which is certainly a good deal higher than it was not too many years ago. So, in my opinion, yes, these are high tax rates.

Mr. HERGER. Could you also tell me, in your opinion—the President's plan would raise the tax credit on—child tax credit from its current $600 to $1,000. What effect do you feel that would have on the low-income taxpayers? Do you feel that would help our economy in the short term?

Mr. GLASSMAN. I think this is a very important question, and I am sorry that we neglected, all three of us neglected to discuss

this, as the Chairman sort of chided us on this. There will be really quite dramatic declines in the amount of money that middle-income and sort of lower-middle-income Americans will be paying in individual income taxes if this passes. One example is that a family making $60,000 a year, a married couple with two children, which, by the way, is the average for a married couple with two children, will see their taxes decline from $3,750 to $2,850, a $900 decline, which is a decline of 24 percent. A family making $40,000 will essentially have their entire tax bill—a similar family with two children will have their entire tax bill wiped out.

I think this is a message—I don't want to criticize the White House because I think they have done generally a good job in presenting this tax package. This is a message which most Americans don't understand. This bill is indeed targeted toward low—and middle-income individuals who pay taxes. It is true that large numbers of people who now currently don't pay taxes or pay very, very little in the way of taxes are not helped that much by it. Middle-income, lower-middle-income Americans, absolutely.

Mr. HERGER. So, therefore, the accusation we hear from some of our friends on the Democrat side of the aisle that this is mainly helping the fat cats just isn't true?

Mr. GLASSMAN. No. Let's look at this way: The general cut across the board that the President has made is actually—actually, there is more of a cut at the lower end, where the bottom bracket goes from 15 percent to 10 percent, than at the top end, where it goes from 39.6 to 35. That is proportionally much greater.

The problem that you have in cutting taxes across the board or anything close to proportionally in this society is that the top 5 percent of taxpayers pay 56 percent of all individual income taxes, and the bottom 50 percent of taxpayers pay 4 percent. So you would have to skew your tax cuts so much in order to get the dollar amounts to be about equal. I think this is actually quite a fair tax cut.

Mr. HERGER. Did I misunderstand what you said? The top 5 percent pay—how much, what percentage?

Mr. GLASSMAN. The top 5 percent of earners, that is to say, people with incomes over $121,000—these are the latest Internal Revenue Service data—pay 56 percent of all individual income taxes.

Mr. HERGER. Over half, 56 percent. The bottom 50 percent of earners pay?

Mr. GLASSMAN. Four percent.

Mr. HERGER. Four percent.

Mr. GLASSMAN. I will also point out that those who pay the 56 percent also have 34 percent of the income. In other words, they pay a much larger percent of the total piece of the pie that they represent. This is only individual income taxes. I don't want to exaggerate this. It does not include payroll taxes, which go to Social Security and so forth.

Mr. HERGER. Right. Mr. Castellani, there have been several proposals that have been offered by our Democrat friends that focus on a one-time increase in Government spending and temporary tax cuts. Do you feel that such policies have any sustained, long-term economic benefit?

Mr. CASTELLANI. No, we do not. We think that the wisdom and the benefit of this proposal is that it provides a substantial stimulus in the short term in the amount of money that it puts into the economy. As importantly, and perhaps more importantly, it provides substantial incentive for growth over the long term, so you really get the best of both that we are looking for to get the economy back on track.

Mr. HERGER. Thank you very much. Thank you, Mr. Chairman.

Chairman THOMAS. The gentleman's time has expired. Does the gentleman from Maryland wish to inquire?

Mr. CARDIN. Thank you, Mr. Chairman. Thank you very much. I am having a hard time following a lot of the logic of this hearing. I just recently had a meeting of the CEOs in Baltimore, and we went over what we could do to try to help this economy. The message I heard from my CEOs was that the Federal Government should have a responsible budget, that it should work for a bipartisan budget, one that exercises restraint, and that would be the most positive message that we could give for growth in this Nation. They reminded me of the pay-go rules we used to have in effect here in Congress that put restraints on spending, on entitlement spending, and on tax expenditures.

Now we seem to have ignored all that. Anything is free to go when it comes to tax cuts. Any tax cut appears to be good, even though we know that it is going to add to the amount of deficits, and even though Alan Greenspan is saying what I think many of us believe, that ultimately large deficits are going to lead to higher interest rates, which is not going to be good for anyone in job creation in our community.

If you were a CEO of a company and you had a bad year, large deficits, you had to borrow money to give dividends, I don't think you would increase your dividends. I really don't think you would do that. Yet you are suggesting that here we are with larger deficits, a reversal of our economy, we have to go out and borrow every dollar that we are going to be paying off in extra taxes, and all of a sudden that is going to be good.

Something is lost in the consistency from the business leadership in our community, here the representatives in Washington. I think in my district they are telling me the right message. It is a message from both Democrats and Republicans, because both parties have been doing things that may be concerned about the deficit. I would expect from our business leadership a little bit more conservative policies as it relates to the deficit, or maybe just deficits aren't important anymore.

Mr. CASTELLANI. Congressman, if I might respond, the Business Roundtable and their CEOs remain absolutely committed to the need to balance the budget, particularly when the economy is operating at a robust level. That is when we are the most concerned about deficits, when the economy is operating at a robust level. Just like any company with a strong balance sheet can use that strong balance sheet when times are not as good to develop new product, to develop new sources of income, we believe that now is the time to use the strong balance sheet that the United States does have to stimulate the kind of growth, coupled with spending discipline, that we will see from this package to get jobs, to get in-

come, to get tax revenue, and ultimately get back to balanced budgets.

Mr. CARDIN. Economists will tell you that if you want to stimulate the economy, put it into the economy now, trigger it all, and have long-term accountability. Yet the dividend exclusion does just the reverse. A small percentage affects 2003. It is a long-term policy. You just said to use your balance sheets to stimulate the economy, but you don't change your balance sheets into long-term deficits. That is, it seems to me, what you are suggesting here.

I really do look to you for leadership on this issue to try to build bridges between the policies here. I must tell you, I am disappointed. I think we could come up with any tax proposal and you would support it. You lose credibility when you do that. I mean, there are legitimate questions as to the President's policies, and I would have hoped we would have had some at least critical discussions of it today. I am just disappointed.

Mr. CASTELLANI. Congressman, we believe that particularly the dividend proposal is the one that provides, for a relatively small investment, a tremendous return. If you look at our models and our results, we are looking at a proposal here that, in total, makes a $687 billion investment—and those were the numbers we had at the time that we ran these models—and gets back a $1.5 trillion increase in GDP.

Mr. CARDIN. Could the President come in with——

Mr. CASTELLANI. That is a heck of a return.

Mr. CARDIN. Is there any tax cut the President would have come in with that you would not have supported?

Mr. CASTELLANI. We are not asking for nor would we be supporting changes to provide incentives for increased investment directly on corporations.

Mr. CARDIN. Does the President have that proposal? I didn't see that.

Mr. CASTELLANI. There have been a number of proposals that have said what we need is accelerated depreciation, more bonus depreciation. What the members of the Business Roundtable are saying is, no, the focus should not be on corporate taxes; the focus should be on stimulating consumer confidence, investor confidence, and consumer spending.

Mr. CARDIN. Mr. Chairman, thank you for your attention.

Chairman THOMAS. I thank the gentleman. Again, he ends right on time. Does the gentleman from Louisiana, Mr. McCrery, wish to inquire?

Mr. MCCRERY. Yes, thank you, Mr. Chairman. Thank you all for your testimony. Mr. Gale, it is always a pleasure to have you with us. You are always well prepared and give us lots of information. Are you an economist?

Mr. GALE. Yes. I have a Ph.D. from Stanford.

Mr. MCCRERY. Well, I am a lawyer, so I hesitate to make economist jokes.

Mr. GALE. Go ahead.

[Laughter.]

Mr. MCCRERY. There are plenty. Is Glenn Hubbard an economist as well?

Mr. GALE. Glenn Hubbard is an economist.

Mr. MCCRERY. He teaches——

Mr. GALE. A very good economist.

Mr. MCCRERY. He teaches at Columbia, right?

Mr. GALE. Yes.

Mr. MCCRERY. Isn't he the main architect of the President's tax proposal?

Mr. GALE. I am not privy to the inside workings of the Administration, but my understanding is what you just said.

Mr. MCCRERY. Well, at least you have heard him extol the virtues of the President's proposal.

Mr. GALE. Certainly.

Mr. MCCRERY. So I think it is fair to say, wouldn't you agree, that good economists like you and Mr. Hubbard can disagree on the impact of the President's proposals.

Mr. GALE. Absolutely, and where we agree is that we both think corporate integration would be a fine idea. Where we disagree is that I think it should be revenue and distributionally neutral, and Mr. Hubbard, if he is the one that proposed this policy, proposed an integration scheme that loses revenue and is regressive.

Mr. MCCRERY. Okay. Thank you. Mr. Glassman, and, really, all three of you, do you think that the dividend proposal in the President's plan would increase the value of the stock market, all other things being equal?

Mr. GLASSMAN. Yes.

Mr. CASTELLANI. Yes.

Mr. GALE. Yes.

Mr. MCCRERY. Okay. Isn't that a good thing?

Mr. GALE. It depends what you are trying to do.

Mr. MCCRERY. Sometimes it is a bad thing.

Mr. GALE. If you are trying to stimulate the economy, there are less expensive ways to do it in the short run. Remember, the bigger stock market boost you get, the smaller is the investment boost you are going to get out of it in the long term. This goes to a complicated issue in corporate finance that Mr. Hubbard has done a lot of work on about the old view versus the new view of corporate finance. Basically the bigger impact you get from abolishing dividends, the less likely you are to get an investment boost from it.

In the extreme, under the new view, the entire dividend cut would show up as a stock market boost on the order of about 10 percent, and there would be no change in investment. Under the old view, you would get about 3 or 4 percent in the stock market, and there would be an investment response.

Mr. MCCRERY. So if we go with the new view and we get a 10-percent increase in the value of the stock market——

Mr. GALE. No new investment.

Mr. MCCRERY. Well——

Mr. GALE. If you want the new view, that is the new view.

Mr. MCCRERY. I hate to bring up Mr. Greenspan, but Mr. Greenspan often talks about the wealth effect of the stock market. He used to a long time ago, 2 years or 3 years ago. Isn't there something to that? I mean, if you increase the value of the stock market by 10 percent, aren't those of us who are invested in the stock market going to feel better about our situations and——

Mr. GALE. Yes, so——

Mr. MCCRERY. Go out perhaps and spend more and——

Mr. GALE. Rough numbers, the stock market is, say, $8 trillion; 10 percent would be $800 billion. If you assume people will spend about 3 percent of that, say—that is the wealth effect—that is about $24 billion in added spending. By comparison, that is about half as big as the rebate in 2001, which was $40 billion. So you are spending hundreds of billions of dollars over the next umpteen years in order to get a $24 billion stimulus now, and that is what I meant when I said earlier that this is not an efficient way to stimulate the economy in the short run. It is much more a kind Rube Goldberg scheme than a direct stimulus.

Mr. MCCRERY. So when Mr. Greenspan used to talk about this wealth effect, he really was just talking about some trivial matter, shouldn't have probably even brought it up.

Mr. GALE. No, no, no. That estimate incorporates the wealth effect. That 3 percent is the wealth effect. It is just that the magnitude of the wealth effect is not big enough to make boosting the stock market the least costly way of stimulating the economy. I am a firm believer in the wealth effect.

Mr. MCCRERY. Mr. Glassman.

Mr. GLASSMAN. Let me just add that I think that with the market as depressed as it is and investors as depressed as they are, I think it is not hard to see that a wealth effect of this nature could give an extra boost. Americans would like to see something going on in the stock market that is positive, and this is not simply an artificial change. This is eliminating a distortion which just about every economist has pointed to as being an inefficiency in the market. We are going to get rid of it if you pass this bill. It will have a major effect on the wealth of individual Americans, and it will make them feel better about investing their money in the stock market, as well, by the way, as in bonds because of the accelerated cuts in tax rates which will increase the return on bonds. You are going to increase the return on stocks and you are going to increase the return on bonds. That will certainly mean that people will make more investments than they are making today.

Mr. MCCRERY. Thank you, Mr. Chairman.

Chairman THOMAS. The gentleman's time has expired. Does the gentleman from California, Mr. Becerra, wish to inquire?

Mr. BECERRA. Thank you, Mr. Chairman.

Mr. Gale, let me go back to something you said a little earlier. I want to be sure I am clear on this. You mentioned that the provisions in the President's tax cut plans—and I am talking now about more than just his tax cut plan that is about $700 billion, but the others that he has as well to make permanent some of the tax cuts that were passed in 2001 and so forth, all those tax cut plans. I think you mentioned that the total effect for small business in most tax cut plans amounts to about 1 percent of the entire cost of all of those plans put together over the next 10 years?

Mr. GALE. Right. I believe that was in reference to the expensing proposal as a share of the total proposed tax cut.

Mr. BECERRA. Let me get some definition on that. We are talking about an entire cost over the next 10 years of about $1.5 trillion, thereabouts, right?

Mr. GALE. Right.

Mr. BECERRA. That includes the tax cut plan that the President has put forward that he is calling his economic growth plan. That includes the plan to make permanent some of the tax cuts that were enacted in 2001. It includes some other tax cut proposals that will be before us at some point as well. Total cost of about $1.5 trillion over 10 years.

Mr. GALE. Right. It does not include tax plans like fixing the AMT, which the budget does not have in it, but which is going to be another $600 billion or $1 trillion.

Mr. BECERRA. Right. So if we wanted to make sure that individuals did not find themselves all of a sudden having to pay a higher tax because they fell into the AMT, then the President would have to include another $600 billion or so on top of the $1.5 trillion to take care of those middle-income Americans who are going to find that they are going to be paying more taxes unless they get that AMT relief?

Mr. GALE. That is exactly right.

Mr. BECERRA. For right now, not to put aside middle America, but for right now just to discuss the $1.5 trillion cost of the President's proposals that we have before us, how much does the expensing provision that is beneficial to small business cost?

Mr. GALE. Approximately 1 percent of it. So if I am doing my math right, I believe it is $15 billion.

Mr. BECERRA. Fifteen or $16 billion. Is there anything else that is specifically targeted toward small business in that $1.5 trillion over the next 10 years in tax cuts?

Mr. GALE. Well, they often talk about the rate cuts in EGTRRA as being targeted toward small business, but this is one of the great bait and switch——

Chairman THOMAS. Mr. Gale, just if I might, to make sure we keep the numbers, because we have Joint Tax numbers. The small business provision is 28.

Mr. GALE. So it is 2 percent.

Chairman THOMAS. Your magnitude is correct. It is just that it is 28.

Mr. GALE. Okay. The rate cuts for EGTRRA are often said to benefit small businesses, in fact, in particular the top rate cut is often said to benefit small businesses. In fact, 98 percent of all small businesses are not subject to the top rate, and the vast majority of them are either in the 0-, 10-, or 15-percent bracket. So, again, as I said, I think it is a bait and switch technique, that there is no reason to think that there would be particularly disproportionate benefits there to small businesses. So I think the answer to your question is yes, that is the main provision.

Mr. BECERRA. Now, you said something else that I would like to return to. You mentioned that if we were not enact these tax cuts that the President has proposed, we could use the moneys that would be otherwise expended to have these tax cuts and place them into the Social Security system, and that we would correct the imbalance that we see coming upon us on the near horizon, the next 30 years or so, so that we would not have any problems over the next 75 years making sure that every individual who retires and qualifies for Social Security over the next 75 years would get exactly what he or she right now believes he or she will get?

Mr. GALE. Right, let me try to clarify that statement. The tax cut proposals in the budget and AMT reform would total between 2.3 and 2.7 percent of GDP as of the last year of the budget horizon. If you assume that they are permanent at that stage and they go forward, that is a cost of 2.3 to 2.7 percent of GDP over the next 75 years.

In contrast, the cost of fixing Social Security over the next 75 years is 0.7 percent of GDP, so it is about a third or less of that total cost of the tax cut. The cost of fixing Medicare part A is on the order of 1 percent of GDP. I am not quite sure about the number. The sum of those two is less than 2.3 to 2.7 percent of GDP.

Mr. BECERRA. So we could take care of the long-term imbalance in Social Security, we could take care of Medicare and put a prescription drug benefit that would be reasonable and something that most seniors could afford into Medicare, and we would still have money left over if we were not to enact these tax cuts?

Mr. GALE. Right. The money available for the tax cuts—the money that is being proposed to be used on tax cuts would be more than sufficient to finance existing obligations under Social Security and Medicare the next 75 years. Whether it would include a prescription drug benefit would depend in part on how big the benefit is.

Mr. BECERRA. Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman. Does the gentleman from Ohio, Mr. Portman, wish to inquire?

Mr. PORTMAN. Thank you, Mr. Chairman. To all three of you, thank you for your good testimony today. Mr. Gale, I just want to follow up on some of your answers to Mr. Becerra regarding the impact on small business. Your testimony says that you don't believe that small business will fare well under this proposal, and you talk about only a 1-percent benefit, after the Chairman talked about the $28 billion, you said maybe 2 percent.

I would just ask you about a couple things. One is expensing. I don't see how expensing cannot help small business. I would love to see our expensing go even further in terms of the levels of businesses that could apply, but section 179 expensing, taking it from $25,000 to $75,000, certainly doesn't have a negative impact on national savings, certainly doesn't have a negative impact on those businesses. They have an advantage of certainly being able to go out and immediately expense what they buy, which is good for them and the economy, but also it is a simplification, a major simplification for these small businesses.

How would that not be a big benefit?

Mr. GALE. Expensing would be a big benefit and would have the effects that you just mentioned. It is the other stuff that has effects in the opposite direction. So, the net effect on a small business would be the positive effects of expensing minus the negative effects of reduced credit availability and higher interest rates.

Mr. PORTMAN. Let's talk about that for a second. I can't imagine expensing would lead to higher interest rates. There is no reason that it should. With regard to the rates, you indicated—I just wrote down what you told Mr. Becerra—that 96 percent of businesses don't pay income taxes at the top couple rates; rather, they pay it at, you said, 0-, 10-, and 15-percent rates. Are you talking

about Subchapter S businesses and the sole proprietors, partnerships?

Mr. GALE. I am talking about the definition of small business as conventionally used in the tax world, the one that Treasury uses. It takes a relatively broad view of what constitutes a small business.

Mr. PORTMAN. I just think your figures are a little misleading when you say that 96 percent of businesses don't pay taxes at the rates that are affected by this. I would say that when you look at the benefit at the top rate—in other words, even taking the rate down to 35 percent. Let's just talk about the top top rate. The majority of that benefit goes to individuals who do have business income. They are Subchapter S owners. They are sole proprietors. They are general partners. They are in these limited liability companies. They are obviously the vast majority of small businesses. They don't incorporate as C corporations, and for you to say that 96 percent of the people in those businesses don't benefit from it, the point is that the majority of the people who will benefit from that do have that business income, and they are the innovators, they are the small businesses. They do tend to be perhaps a little larger small businesses than the very small businesses that would benefit from section 179, which is a nice compliment, I think. I just think that is a little misleading to say that 96 percent of them aren't in that category. In terms of the value of the business and the tax impact to them, it is far in excess of the 4 percent that you would indicate. I don't know what it is, but Treasury has told us that the majority of them benefit, the majority of it would go to people who have business income.

Mr. GALE. There are two issues here. I don't disagree with what you said. There are two issues.

One is the vast share of returns that report small business income, the 98 percent I think it is, not 96, are not in the top income tax bracket.

It is also true, as you said, that a significant share of the returns in the top income bracket have business income, but there is a concern about what that means for small business investment because people suspect, myself included, but others as well, suspect that a lot of that is purely passive income and is not sort of entrepreneurship as we would like to think about it.

Mr. PORTMAN. I think we don't need to suspect, as much as we are suspecting, because there is good data on at least the significant number you mentioned. It is over half. In terms of passive versus active income, the point would be that most small businesses are incorporated as individuals; in other words Sub S or sole proprietors or general partners. Those individuals will get benefit from this. It will help small businesses, and I would just hope you can work that into your small business calculation when you say they don't fare well under this.

I think it is a significant impact. It certainly is in my district where the vast majority of businesses are small businesses, they are the ones who are creating all of the new jobs. Frankly, our large businesses are still downsizing.

One other question I have for you, and Mr. Glassman and Mr. Castellani should jump in here, too, but you talked about these

macroeconomic impacts of the President's proposal. I know the BRT has its own impacts, the statements they have done. Five hundred thousand new jobs a year I think for the next 5 years is what the BRT economists show.

You mentioned the macroeconomic advisers, a study done in 2003, you said no effect on GDP between 2003 and 2007. I know the macroeconomic advisers is not in line with most of the other groups out there that have done analyses, but what we get from them is not that. In fact, we have information that they say that you will see an increase in growth, 0.5 percentage points and 1 percentage point—0.5 this year and 1 percent in 2004, just something you might want to check in terms of the facts.

Mr. GALE. That is accurate, but the net effect over the 5-year period is zero. There is a short-term boost in that model, but the net effect over the 5-year period is zero because it——

Mr. PORTMAN. That means it is stimulative. That means it is stimulative over the next couple of years. That is great.

Mr. GALE. Qualitatively, yes.

Mr. PORTMAN. Thank you, Mr. Gale.

Mr. GLASSMAN. Could I just add something to Mr. Gale's response?

Mr. PORTMAN. It is up to the Chairman.

Chairman THOMAS. Briefly.

Mr. GLASSMAN. Even if Mr. Gale is correct—and I don't think he is—that there are so many small businesses, I guess that includes like baby sitters or something who don't make that much money, all tax rates are being cut under this bill by 10 percent, minimum. So if you want to call those small businesses, and I am sure they are, they are all going to benefit from this.

Mr. GALE. That is just factually wrong.

Mr. GLASSMAN. Second, many small businesses——

Mr. GALE. That is factually——

Mr. GLASSMAN. Many small businesses——

Mr. GALE. It is factually incorrect.

Mr. GLASSMAN. Many small businesses will move from an unincorporated status and maybe even an unlisted status to a new status because their shareholders will begin to get tax-free dividends. So I think this will have a huge and important effect on small businesses.

Mr. GALE. It is factually incorrect to say that all rates are coming down. The 15-percent rate is not changing, and taxpayers that are on the AMT, which is disproportionately a large share of small businesses, do not have reductions in their marginal tax rates.

All told, according to Treasury data, 64 percent of taxpayers—taxpayers, not filers—64 percent of taxpayers will not get a cut in marginal tax rates due to the 2001 tax cut, and that is because they are either in the 15-percent bracket, which has not changed, or they are on the AMT.

So the majority of taxpayers out there—that is people with positive income tax liability—do not get a reduction in marginal tax rates under the entire extra package according to Treasury data.

Chairman THOMAS. The gentleman's time has expired. Does the gentleman from North Dakota wish to inquire?

Mr. POMEROY. Thank you, Mr. Chairman. I want to salute each of you for your roles over the years in advancing ideas.

Mr. Glassman, you have advanced many ideas, some of them I have found intriguing, many of them I have disagreed with, but you have contributed to the debate in town. Let us just review some of those ideas.

Do you think that the long-term commitment of this country to Social Security and Americans' expectation of Social Security benefits is pleasantly defined as something that should continue?

Mr. GLASSMAN. Yes, sir, I do, although I do think it is imperative that we reform the Social Security system. I think people who are currently on Social Security or who anticipate getting Social Security within the next few years, that is a guarantee that this country needs to meet and will meet.

Mr. POMEROY. The baby boomers will be perhaps a little more away than that. Do you support substantial reform relative to baby boomers or should they be entitled to the guaranteed annuity as presently——

Mr. GLASSMAN. Yes, I do, Congressman.

Mr. POMEROY. You do.

Mr. GLASSMAN. Yes, as a matter of choice. In other words, I think baby boomers can make a decision—and don't forget baby boomers go all the way from 1947, that is me, to 1964. So some of them are, what, 38 years old now.

Mr. POMEROY. We have such little time. I will just have to cut to the chase. I hear you saying you think it ought to be substantially reformed, while maintaining existing guarantees to people on or near Social Security.

Mr. GLASSMAN. Yes.

Mr. POMEROY. How about Medicare, do you think that going forward we should maintain the commitment of Medicare as an entitlement to American people, including baby boomers, going forward?

Mr. GLASSMAN. I think that Medicare needs, and this is not my field, but I think Medicare needs, again, significant reform.

Mr. POMEROY. You have also opined on tax reform in years past. Flat tax, tend to favor it?

Mr. GLASSMAN. Yes, but I don't——

Mr. POMEROY. The thing about——

Mr. GLASSMAN. Let me just add that I think that the rate part, sort of the part that attracts all the attention, everybody is at the same rate, is probably the least-important part. I think we need to tax income only once, we need to eliminate deductions and special exclusions. I think that is the key.

Mr. POMEROY. In light of your long analysis of tax reform, it is not surprising to see you participating in this date, an interesting welcome voice. One of the things that strikes me as different about this tax reform debate from others is that it is not paid for. We have looked at other types of tax reform. Packages had revenue off-sets to deal with the revenue cuts. This is just cuts.

So, we are talking about kind of the beneficial results of tax cuts, and yet notably absent from the discussion are the economic consequences of soaring deficits. Mr. Gale, perhaps if any of the panel

has spoken to that, you have a bit. What are the effects on the overall economy of soaring deficits?

Mr. GALE. The key effect is the reduction in national saving that occurs, and that occurs if, say, the government borrows $100 billion more, if the private sector then turns around and saves about $25 billion than it otherwise would have, which is what the evidence suggests, the national savings has gone down by $75 billion. National savings is the sum of public and private saving.

Mr. POMEROY. Savings rates relates to economic performance.

Mr. GALE. Right. The amount of national saving the country does relates directly to how much capital it owns, which then relates to its future income, and so there is a reduction in future income. Just to give you a rough calculation, from January 2001 to this January, the 10-year budget surplus projection fell by $5.6 trillion.

If you go through the calculation the way I just mentioned and apply a conservative interest rate to that capital, you are looking at a reduction in income in 2012 of about $1,500 per household in this country.

Mr. POMEROY. I will submit for the record the David Broder column appearing in today's Post, where he cites the Committee of Economic Development, a blue-ribbon organization of corporate chief executive officers and civic leaders. They weigh in with great concern about this plan, citing, and I quote, "Deficits of this scale over that many years would spell economic peril at any time the business executives say because they reduce the pool of national savings, diminish the investments and make us more dependent on foreign investors."

[The information follows:]

The Washington Post

The CEO's Dim View of Deficits

By David S. Broder
Columnist
WEDNESDAY, MARCH 5, 2003; Page A21

From the heart of the business establishment comes a statement criticizing and rejecting the Bush tax cuts—a stunning repudiation of the president's fundamental economic strategy delivered by the very corporate leaders who make the investment decisions on which recovery and growth turn.

Along with the criticism of the Administration plan leveled last month by Federal Reserve Board Chairman Alan Greenspan, the report being issued today by the Committee for Economic Development, a blue-ribbon organization of corporate chief executive officers and civic leaders, is a warning that President Bush's policies risk long-term damage to Americans' prosperity and the government's fiscal stability.

While Administration officials defend the deficits in store for this year and next as small by historical standards and temporary, the Committee says that more realistic calculations show that over the next decade we can expect "annual deficits of $300-$400 billion, increasing as far as the eye can see."

Those estimates do not take into account the new tax cuts proposed by Bush in January and now beginning to make their way through the House of Representatives. "All told, the new budget proposals, if enacted, would raise the 10-year deficit by about $2.7 trillion and annual deficits 10 years from now by about $500 billion," the report says. And none of this, by the way, factors in the costs of a possible war with Iraq and its aftermath.

Deficits of this scale, over that many years, would spell economic peril at any time, the business executives say, because they reduce the pool of national savings, diminish needed investments and make us more dependent on foreign creditors.

But they are particularly dangerous at this moment, because in only 5 years, starting in 2008, the vanguard of the baby boomers will reach early retirement age and the demands on Social Security, Medicare and private health and retirement systems will rise dramatically.

The workforce is likely to grow barely at all in subsequent decades, thanks to continuing low birthrates, which means that overall economic growth will be limited. Meanwhile, lengthening life expectancy and the sheer number of boomers will cause retirement and health care costs to explode.

"Staying on our present track, spending for Social Security, Medicare and Medicaid skyrockets, while revenues fail to keep pace. The Federal Government deficit would balloon," weakening an already poor savings rate, and "by the 2020s, per-capita income growth would have fallen by more than half, and by 2040 the model predicts growth rates very nearly zero. . . . Perhaps for the first time in this country's history, most Americans could no longer expect their children and grandchildren to have higher living standards than their own."

The hardheaded executives dismiss as unrealistic any hope that the United States can simply "grow its way out of" the interlinked challenges of dangerous deficits and rising demands from its aging population.

Given the scale of the challenge, no single fix—whether on the spending or revenue side—will be sufficient. The policy recommendations embrace reform of Social Security and Medicare, careful scrutiny of Pentagon and homeland defense priorities and provision for expanded investment in education, research and infrastructure—the building blocks of future growth.

But the main point of the report is that "we must begin immediately in the 2004 budget to deal with the explosion of the long-term deficit."

That does not mean raising taxes or cutting spending now, while the economy is still struggling. But it does mean the government should not adopt "any short-term stimulus program that is not combined with a plan to restore longer term budget balance. We are specifically concerned that the Jobs and Growth Package proposed by the Administration, which would raise the cumulative 2004–2013 deficit by about $920 billion (including interest) and raise the annual deficit 10 years from now by about $100 billion, does not meet this test."

Over the decades ahead, considering the demands of an aging population, the threat of terrorism and the growing international obligations of the United States, the Committee for Economic Development says it is "extremely unlikely that the long-term budget problem can be solved without additional revenues. We therefore urge the Administration and Congress to forgo at this time any additional tax reductions," including any move to make permanent the tax cuts passed in the make-believe atmosphere of projected budget surpluses in 2001.

It is a sobering message and, considering the source, not one to be ignored.

Mr. POMEROY. As we talk about whether or not the market gets a little juice from the dividend proposal, it seems to me we are not talking about whether or not we are strengthening the long-term fundamental performance of the economy, and that will ultimately have more bearing on stock price than an incidental effect on dividends; is that correct, Mr. Gale?

Mr. GALE. That is exactly right. The President said that he did not want to pass the burden of his current policies on to future generations, but that is exactly what his budget would do, and it would do it in massive amounts by increasing the amount of public debt.

Mr. POMEROY. Thank you.

Chairman THOMAS. The gentleman from Missouri would be recognized. Would he yield to the Chair?

Mr. HULSHOF. I would be happy to be recognized and yield to the Chair.

Chairman THOMAS. Thank the gentleman. I would like to pose a question which each of you if you desire to respond to can. Is every dollar that you spend in deficit equal to any other dollar that you spend in deficit?

Mr. GLASSMAN. No, and I think that is a very important question. Let me actually frame it in a slightly different way, Mr. Chairman, if I may. I think if Milton Friedman were here, he would do it this way.

What counts is what the government spends and what it spends on. The question of where that money comes from is a separate issue. It can only come from two sources. It can either come from borrowing or it can come from taxes. Either of those two sources pull money out of the private sector, so you better be sure you are spending money on a good thing before you pull money out of the private sector.

Really, it does not make that much difference whether the money comes out as taxes or as debt because it is coming from the same source. In fact, I would argue that today this country is paying very little on its debt. Just maybe, given this choice, if we think that the government is spending on the right things, that in fact this may be a good time—I hate to bring up such a remarkable thought—but this may be a good time to choose debt over taxes.

Chairman THOMAS. Any other brief response on the gentleman from Missouri's time?

Mr. GALE. The short answer is, no, they are not all the same. The tax cuts, spending cuts have two effects; one is their direct effect on the economy, which can differ across policies, and the other is the drag on national saving.

I do want to mention this is not a good time for the country to borrow, even though interest rates are low, because we have the baby boomers retiring in a few years, and the budget deficit going off the table at that point.

Chairman THOMAS. I would only say, not to extend the discussion, that sometimes, in the old cliche, you have to spend money to make money, and that what you spend that deficit dollar on I think does make a difference, either growth or consumption.

The gentleman from Missouri is appreciated, and the Chair will be as generous as the Members allow him.

Mr. HULSHOF. I appreciate that. Thank you for asking my question, Mr. Chairman.

In fact, just as a comment, I am not sure if either of the three of you had a chance to review Secretary Snow's testimony from yesterday. He made the same point, Mr. Glassman; that is, and I think it was under questions from Mr. Tanner on the debt service, that we are actually paying now less on the debt service because of interest rates. Mr. Gale, you are cringing a bit. Do you disagree with what the Treasury Secretary told us yesterday?

Mr. GALE. Oh, sorry. I wasn't cringing, I was just formulating my response. I want to emphasize the budget deficit this year, the budget deficit next year is not a big deal. We had a stock market come down, we had a recession, we may have a war. Short-term budget deficits are not that big a deal. The big problem is that 10 years from now the deficits go off the map. They increase dramatically as the boomers start retiring, and therefore we have sort of a medium-term issue in the next 3 to 10 years, when we can save for retirement.

What this Administration's budget does is it takes that 3- to 10-year period and it creates deficits as far as we can see. That is the

new troubling thing. The old troubling thing is the long-term forecast, but the new troubling thing in this budget is that, even over the next 10 years, even with full employment, no war, no AMT fix, we are looking at structural deficits of 1.5 percent of GDP, and that is a really bad situation to head into the retirement of the baby boomers.

Mr. HULSHOF. Let me state and echo, Mr. Gale, what Mr. McCrery said. I do appreciate your points of view. In fact, I think, if memory serves, we assembled a panel that you were on right after the September 11th. Wasn't that a closed-door session that we had, and you were one of those that we were bouncing around some ideas of what we could do in the interim after September 11th, a dramatic impact, and certainly we all agree I think that it had a dramatic negative impact on the national economy.

Was there anything in EGTRRA that was a good thing, looking back, Mr. Gale? The $300 and $600 rebates, the elimination of the marriage penalty?

Mr. GALE. The rebates certainly had some short-term impact. They couldn't have been that big because they were only $40 billion overall, and estimates look like a third or half of them were spent so that is up to $20 billion in a $10-trillion economy, but that is sort of a shred of silver lining, I guess.

We don't have time to go into what I think of all of the problems that EGTRRA created, but that is certainly one positive thing.

Mr. HULSHOF. As a final comment, Mr. Chairman, and I know my time now has—the sands in the hourglass have dwindled out, but——

Chairman THOMAS. I would tell the gentleman he has a slightly larger hourglass than most.

[Laughter.]

Mr. HULSHOF. I appreciate that. I would say, and there is something, and we don't have a chance, Mr. Gale, to talk about it, but maybe if you could just give me a sound bite on your comment to an earlier question. So are you saying that we should return to the Nixon-era days of revenue sharing with the States?

I heard you say that States are now really hurting. I know Mr. Keating is coming and the comptroller of the State of New York is coming. Is it that we should then open up the coffers and then give the States the money? Should my taxpayers in Missouri help plug the $35-billion deficit in the State of California? What is it that you are proposing as far as helping the States.

Mr. GALE. The States are bringing the economy down in the short run by raising taxes and cutting spending, and they may well be bringing the economy down in the long run right now because the way they are cutting spending is on things like education, which cannot have good long-term effects; corrections budgets, which scares the daylights out of me; health care, which again can't have good long-term effects.

So I would certainly agree that there is an issue concerning what the best way to structure the relationship between Federal and State relations are. There is another issue about whether the States should really have balanced budget rules, and those should all be addressed, but as a positive matter, as sort of a statement of fact, if you wanted to stimulate the economy right now, fun-

neling the money to the States, given their situation and their budget rules, would be an effective way to do it.

Chairman THOMAS. I thought the Chair heard Dr. Gale talk about dynamic scoring on tax cuts and spending, in terms of effects on the economy. Does the gentleman from Massachusetts wish to inquire?

Mr. NEAL. Thank you very much, Mr. Chairman. Mr. McCrery, in his comments earlier, alluded with some humor to the uncertainty of projections that economists make. We are dealing with some firm data.

Mr. Castellani, what is it that you object to about the policies of Mr. Bentsen, and Mr. Rubin, and Mr. Summers?

Mr. CASTELLANI. There is nothing that I am objecting to or nothing I can think of that we would object to about the policies. I think the current situation is different. We have an economy that is growing at a very anemic rate, certainly not enough to create jobs, certainly not enough to sustain investment.

Irrespective of anyone's view here, my colleagues here on this panel or anyone's view of how it should be done, all of the issues are exacerbated if the economy continues to limp along in the long term.

Mr. NEAL. Well, would you say that those three Treasury Secretaries, and the job that they did, was a pretty good job during those years?

Mr. CASTELLANI. By all means, for those times.

Mr. NEAL. For those times? So you would argue that those policies that they employed worked pretty well.

Mr. CASTELLANI. I would say that whether or not those policies directly affected the economy or not, they were certainly benefited by a robust economy and substantial revenues.

Mr. NEAL. Well, the Majority Leader here in the House at the time that we took some very tough votes, and let me give Bush 1 some credit, too, for having had the courage to do the right thing at the right moment, the Majority Leader at the time in the House said that we were headed to the worst Depression in the history of America. The leader of the Budget Committee at the time, a gentleman from Ohio, said that we were headed to fiscal armageddon.

I don't understand the notion that we had to undo immediately a couple of years ago all of the things that they put in place arguing that, for some reason, if we changed dramatically, then there must have been some fault line that was discovered along the way.

Mr. CASTELLANI. Well, Congressman, I can't conceive, and we can't conceive, of a circumstance where the economy would be benefited, and job creation would be enhanced, and investment would be enhanced by raising taxes at this point, which was, in fact, done in 1992.

Mr. NEAL. Mr. Castellani, it plays to the notion that Mr. Cardin raised, for those of us on this side, you are going to come in and argue for tax cuts no matter what the economy is doing. If the evidence is put to you to the contrary, it is not going to make a bit of difference. You are going to simply say "cut taxes."

Mr. CASTELLANI. In this circumstance, we feel that these cuts, aimed at consumers, and aimed at investors, are what will provide

the biggest incentive for the economy to grow to overcome the circumstances that are keeping it from growing at a robust rate.

Mr. NEAL. How are we going to pay for the impending war in Iraq? Have you given that any thought?

Mr. CASTELLANI. As I had said earlier, just like a business would use its strong balance sheet, we do have a strong balance sheet in this country, and whatever the cost is, revenues will be enhanced as the economy picks up and grows at a 4-percent rate, a 4.5-percent rate, and brings back the kind of robust job growth and investment that will bring back the revenues.

Mr. NEAL. Mr. Glassman, I do enjoy reading your column and follow you with a lot of interest.

Mr. GLASSMAN. Thank you.

Mr. NEAL. Over the past few weeks, I have received a number of letters from groups, largely because of the work that I have done over the years, opposing the dividend provision because of its detrimental effect on low-income housing, and I would like to enter into the record letters from GMAC Commercial Holding of Denver, Colorado, Penrose Properties of Philadelphia, the Massachusetts Association of Community Development Corporations, the NCB Development Corporation of Washington, DC, and the National Coalition of State Housing Administrators.

I have also received a similar letter from the Bond Market Association regarding the effect on tax-exempt bonds, and, Mr. Chairman, I would like this entered into the record, as well.

Chairman THOMAS. Without objection.

[The letters follow:]

Massachusetts Association of Community Development Corporations
Boston, Massachusetts 02111
February 11, 2003

The Honorable Richard Neal U.S. Congressman
2236 Rayburn House Office Building
Washington. D.C. 20515–2102

Dear Congressman Neal:

On behalf of the Massachusetts Association of Community Development Corporations (MACDC) and its 68 members, I am writing to urge you to oppose President Bush's $674 billion tax cut, in particular the dividend exemption.

MACDC is very concerned that the President's dividend exemption proposal will have an unintended consequence of undermining Federal housing policy. According to recent reports from Ernst & Young and Forbes Magazine, the President's proposal to eliminate tax on dividends may devastate the Low Income Housing Tax Credit. The value of tax credit investments to corporations would be greatly diminished, if not entirely eliminated, causing corporations to avoid investments in tax credits in order to maximize tax-free dividends to their shareholders.

Tax credit programs have become the major source of affordable housing and community development funding in the U.S. For example, the Low Income Housing Tax Credit generates $6 billion annually in private investment and produces virtually all of America's new affordable rental housing. As you may know, CDCs build strong communities in large part through affordable housing development, and our members rely substantially on the Low Income Housing Tax Credit program. Without this program, CDCs will not be able to achieve their 2 year goal of creating and preserving 3,000 homes during 2003 and 2004. With Massachusetts facing a serious housing crisis, we need every home we can build.

On behalf of the CDC community in Massachusetts, MACDC respectfully suggests that the $674 billion could be put to much better use by restoring full funding for the Community Development Block Grant program, the HOME program, the Economic Development Administration, Rural Housing and Economic Development pro-

gram, Community Development Financial Institutions Fund, the SBA micro lending and PRIME programs, and the Job Opportunities for Low Income People program.

Thank you,

Joseph Kriesberg
President and CEO

GMAC Commercial Holding Capitol Corp.
Denver, Colorado 80202
January 6, 2003

The Honorable Richard E. Neal
2133 Rayburn HOB
Washington, DC 20515–102

Re: Proposed Dividend Tax Exemption and the Low-Income Housing Tax Credit

Dear Richard,

I am writing you to express our firm's deep concern over the negative impact on multifamily affordable housing from the Administration's proposal to exempt shareholders from tax on corporate dividends. Specifically, this legislation as proposed would very negatively impact the viability of Low-Income Housing Tax Credits ("LIHTC").

This public-private partnership model has efficiently delivered over 1.3 million (approximately 100,000+ annually) affordable multifamily homes . . . a crucial element in meeting the housing needs of the 40 million Americans who spend more than half their income for housing or live in substandard housing. LIHTC enjoys overwhelming bi-partisan support as the United States' primary multifamily affordable housing delivery vehicle. Recent legislation increasing the program was cosponsored by 85% of Congress, nearly equally Republican and Democratic.

Your assistance to helping solve this very important issue as quickly as possible is most urgently requested. I have attached a one-page summary of this issue. I would very much welcome discussing this in more detail.

Sincerely,

David C. Smith
President

Penrose Properties, Inc.
Philadelphia, Pennsylvania 19103–7332
February 10, 2003

The Honorable Richard E. Neal, D–MA
United States House of Representatives
House Committee on Ways and Means
1102 Longworth House Office Bldg.
Washington, D.C. 20515–6348

Dear Mr. Neal:

We are concerned that the Treasury Department's formulation of President Bush's policy initiative to reform the Internal Revenue Code by ending the double taxation of corporate dividends will seriously jeopardize the production of affordable housing by reducing the value of the low income housing tax credit (the "LIHTC"). We urge you to ensure that no harm is done to the LIHTC when you consider legislation designed to incorporate the Administration's policy to end the double taxation of corporate dividends (the "dividend proposal").

As you may know, at least 40 percent of annual affordable housing starts are made possible through the LIHTC. It began under the Reagan Administration as a means to provide a more efficient means of meeting the Nation's affordable housing needs than direct subsidies. The program has proved to be a rousing success. Under the Treasury Department's formulation of the dividend proposal, however, the efficiency which is the hallmark of this program would be sharply reduced. To demonstrate this, we have attached an example illustrating how the LIHTC works under current law and how it would be affected under the Treasury's formulation of the dividend proposal.

We are also very concerned that the value' of the new markets tax credit, enacted in 2000, and President Bush's new homeownership tax credit will drop significantly under the Treasury's formulation of the dividend proposal. We urge you to preserve the value of these credits as well in any legislation which you consider implementing the dividend proposal.

We look forward to working with you to preserve the LIHTC as a critical engine behind the production of affordable housing in our Nation. It was initiated by President Reagan, extended and strengthened by President George H.W. Bush and permanently extended and increased by President Clinton. It is a bipartisan program that works. Let's not break it by trying to fix the Internal Revenue Code, particularly at a time that our Nation's economy can ill afford it.

Kind regards,

Mark H. Dambly
Vice President

NCB Development Corp.
Washington, DC 20006
March 4, 2003

The Honorable Richard E, Neal
2133 Rayburn House Office Building
United States House of Representatives
Washington, DC 20515

Dear Congressman Neal:

The NCB Development Corp. (NCBDC), as a member of the New Markets Tax Credit Coalition (NMTCC), Community Homeownership Credit Coalition (CHCC) and a coalition of more than 63 national and local organizations that have signed a statement sponsored by the National Council of State Housing Agencies (NCSHA) regarding the dividend exemption, is gravely concerned about the President's proposal to end double taxation of corporate dividends and its potential impact on community reinvestment tax credits, including the New Market Tax Credit (NMTC), Low Income Housing Tax Credit (LIHTC), Historic Rehabilitation Tax Credit, and the Administration's own proposed Homeownership Tax Credit.

The NMTC, as part of the Community Renewal Tax Relief Act of 2000, (signed into law on Thursday, December 21, 2000) is designed to spur $15 billion in community economic development investments over a seven-year period (2001–2007). NMTC represents the largest new Federal investment in lower income community development since the mid-eighties.

NCBDC is a national mission driven non-profit organization who, for 25 years, has provided innovative financial development services and technical assistance to improve the lives of low-income individuals, families, and communities. By creatively investing in our neighborhoods, advocating elected officials around public policy, and collaborating with other national and local community-based organizations, NCBDC helps charter schools finance facilities; enables community health centers to expand to serve more patients; preserves and creates affordable housing; and helps socially responsible businesses thrive.

The Treasury Department's Community Development Financial Institutions Fund (CDFI) is expected to announce the initial round of the NMTC allocations this week or early March, totaling nearly $2.5 billion (after the Fund received applications requesting mores than 10 times the amount or $26 billion). The Administration's proposal will slow or stall corporations, the anticipated principal investors in the NMTC. They will be forced to choose between reducing corporate tax liability and maximizing shareholder benefits or reducing tax liability and investing in revitalization projects through the NMTC until the dividend exemption proposal is resolved. The number of applications received represents distressed communities across the country.

A recent report released by Ernst & Young, LIP and commissioned by the NCSHA suggests that the value of tax credit investments to corporations would be greatly diminished or entirely eliminated, as corporate investment currently accounts for 98 percent of the equity capital generated by the LIHTC. The LIHTC generates more than $6 billion annually in private investment, and produces a large proportion of America's affordable rental housing. The Administration's dividend exclusion proposal will drastically reduce or eliminate the LIHTC.

We applaud the work of the Administration in launching the NMTC program, and their inclusion of the community home ownership tax credit in the fiscal year 2004

budget. However, NCBDC is concerned that if the proposal is passed in its current form, the outcome will be devastating to ALL community reinvestment tax credits, and to the low income and displaced communities they serve, This private investment has been integral to our organization and others like us to support small businesses and provide services, homes and opportunities to hard working families and the elderly across the country. NCBDC will continue to examine the potential impacts of the dividend exclusion proposal and will share that information with you, the U.S. Congress, and the Administration.

If you have any questions, please contact me at 202–218–7289 or jholdsclaw@ncbdc.org. Thank you for your consideration in this matter.

Sincerely,

John M. Holdsclaw IV
Director, Policy Development

National Trust for Historic Preservation
Washington, DC 20036
February 27, 2003

The Honorable Richard E. Neal
U.S. House of Representatives
2133 Rayburn House Office Building
Washington, DC 20515–2102

Dear Congressman Neal:

On behalf of the National Trust for Historic Preservation I am writing to express our concern to Congress that the Administration's proposal to eliminate double taxation of corporate dividends would do serious harm to the vitality of the Federal Historic Preservation Tax Credit (HPTC) program. We also have serious reservations about its potentially adverse affect on other tax credits that link historic preservation with community revitalization and housing production such as the Low-Income Housing Tax Credit and the New Markets Tax Credit. The National Trust is a private, non-profit organization dedicated to protecting historic buildings and the neighborhoods they anchor. It has extensive experience with the use of HPTCs and other credits in stimulating the beneficial re-use of historic and older buildings for offices, retail space, and places to live. As Congress prepares to consider the Administration's proposal, we urge your support for a dividend exclusion plan that would have no adverse effect on tax credits.

HPTCs are one of the nation's most successful and cost-effective tools for stimulating community revitalization. The program fosters private sector rehabilitation of historic buildings and promotes economic growth. At the same time it provides a strong alternative to government ownership and management of such historic properties. If the dividend exclusion were enacted in its present form, the National Trust's preliminary analysis indicates that corporations would opt to increase the distribution of tax-free dividends (or deemed dividends) to shareholders at the expense of investing in tax credits such as the HPTC. If this happens, the community development and historic preservation sectors would lose one of their most valuable resources for bringing new life to downtowns, and low- and moderate-income areas—the same, places where, most of America's older buildings are located.

The basic structure of the HPTC was enacted as part of President Reagan's Economic Recovery Tax Act 1981. The program currently provides for a 20% credit for eligible expenditures related to the rehabilitation of properties listed on the National Register of Historic Places or located in historic districts. A 10% credit is currently allowed for similar expenditures on older, non-historic buildings. The passive activity provisions added to the Internal Revenue Code in 1986 preclude many individuals from claiming HPTCs. As a result, today nearly 80% of all HPTCs are claimed by corporate taxpayers. Given this limitation, HPTCs would be placed at a distinct disadvantage were the Administration's dividend exclusion proposal to add a disincentive for corporate taxpayers to participate in the program as well.

Since their inception, historic preservation tax incentives have produced significant benefits for the nation. The National Park Service, which administers the program in cooperation with the Internal Revenue Service, calculates that:

- the tax incentives have stimulated private investment of over $18 billion;
- more than 27,000 historic properties have been rehabilitated and saved;
- more than 149,000 housing units have been rehabilitated;
- more than 75,000 new housing units have been created, including over 30,000 for low and moderate-income families.

Despite this economic impact, according to OMB the combined total tax expenditure for both the 10% tax credit and the 20% tax credit in 2002 was only $230 million.

The effect of any destabilization of the HPTC and other tax credits would be felt well beyond the walls of the nation's older and historic buildings. Rehabilitation of existing structures has a greater economic result than comparable dollars invested in new construction. Research indicates that if a community is deciding between spending one million dollars in new construction and spending one million dollars in rehabilitation, the rehabilitation approach offers the following advantages:

- $120,000 more will initially stay in the community;
- as many as nine more construction jobs will be created;
- 4.7 more new jobs will be created;
- household incomes in the community will increase by $107 more than new construction; and
- retail sales in the community will increase $142,000 as a result of that one million dollars of rehabilitation expenditure—$34,000 more than with one million dollars of new construction.

Destabilization of the HPTC marketplace would also adversely impact the 21 states that have created state historic preservation tax credits, many of which are intentionally designed to "piggyback" off of the HPTC.

The National Trust recognizes the Administration's support for the HPTC and does not believe the dividend exclusion proposal was intended to put this valuable program at risk. However, we advise Congress that if the proposal is implemented in its current form the outcome could be devastating for America's older and historic communities.

I urge your consideration for a formulation of the dividend exclusion proposal that would not penalize corporate taxpayers who participate in the HPTC program and adversely affect other credits that benefit neighborhoods most in-need. I would welcome the opportunity to meet with you to discuss these matters further.

Warmest regards.

Sincerely,

Richard Moe

National Council of State Housing Agencies
Washington, DC 20001
February 25, 2003

The Honorable John W. Snow
Secretary, United States Department of the Treasury
1500 Pennsylvania Avenue, NW, Suite 3330
Washington, DC 20220

Dear Secretary Snow:

The National Council of State Housing Agencies (NCSHA), on behalf of the state Low Income Housing Tax Credit (Housing Credit) allocators, is pleased to share with you, "The Impact of the Dividend Exclusion Proposal on the Production of Affordable Housing," a February 2003 report prepared by Ernst & Young LLP at NCSHA's request. This report objectively documents the unintended adverse impact the Administration's proposed dividend tax exclusion would have on the production of affordable rental housing in America.

Neither NCSHA nor Ernst & Young has a position on the dividend proposal itself. NCSHA offers the Administration and the Congress this report to help build understanding of the implications of the proposal for affordable housing and, specifically, the Housing Credit. We hope the report will also be useful to you in assessing the dividend proposal's impact on other important housing and community revitalization tools, such as the Administration's proposed Homeownership Credit, the New Markets Tax Credit, and the Historic Preservation Tax Credit.

Ernst & Young estimates that 35 percent fewer Housing Credit apartments—40,000 fewer apartments serving about 100,000 residents—would be produced annually if the dividend exclusion proposal were enacted as proposed. Its analysis shows that corporate Housing Credit investors—which account for 98 percent of Housing Credit equity raised annually—would limit the amount of capital they invest in Housing Credits or lower the price they are willing to pay for them, reducing the amount of Housing Credit equity available to produce affordable rental housing.

NCSHA believes the total impact may be even greater. Ernst & Young does not take into account, for example, the impact of higher interest rates on tax-exempt housing bonds almost certain to result from enactment of the dividend proposal. Forty-two percent of Housing Credit apartments developed annually are financed with tax-exempt bonds.

America cannot afford the loss of a single affordable apartment, let alone 40,000 Housing Credit apartments annually. As of 2001, over seven million American renter families—one in five—suffer severe housing affordability problems. They spend more than half of their income on rent or live in substandard housing. Meanwhile, more than 150,000 apartments are lost to the low-cost rental housing inventory each year due to rent increases, abandonment, and deterioration.

In the face of this enormous need, the Housing Credit is the only significant producer of affordable rental housing. The Housing Credit is a federal tax incentive Congress has empowered states to use to encourage private investment in the construction and rehabilitation of privately owned apartments dedicated for 30 years or more at restricted rents to families with incomes of 60 percent of area median income or less. In creating the Housing Credit in 1986, Congress recognized that apartments simply cost too much to build, without some form of development tax incentive or subsidy, to rent at rates affordable to low-income families.

The Housing Credit is an enormous success. Since 1986, it has financed 1.5 million apartments to respond to the severe and growing shortage of decent, safe, and affordable housing for low-income Americans—working families, seniors, the homeless, and people with special needs all across the country. Each year, the Housing Credit finances 115,000 more apartments.

Often, Housing Credit tenants earn far less than federal income limits permit; in 1997, the GAO found the average Housing Credit tenant earned 38 percent of area median income. A majority of Housing Credit properties are dedicated to low-income use for periods longer than 30 years, many for 50 years or more.

The Housing Credit works because it allows states, not the federal government, to decide how to respond most effectively to their housing needs. It also harnesses the resources and discipline of the private sector, attracting $6 billion in private sector capital annually and giving the private sector a stake in the success of the housing this investment builds.

The Housing Credit has become more and more efficient over time, due in large part to Congress' 1993 decision to make the Housing Credit permanent and increased corporate investment. Prices investors pay for Housing Credits have risen approximately 50 percent since the program's creation in 1986, increasing the amount of equity capital that goes directly into affordable housing production.

The Housing Credit is not only good for housing; it is good for the economy. Housing Credit apartments account for up to 40 percent of all apartment production annually. Each year, the construction and operation of Housing Credit properties generates approximately $8.8 billion of income for the economy, creates 167,000 jobs, and produces $1.35 billion in revenue for cash-strapped local governments.

The Housing Credit enjoys strong, bipartisan support in the Congress. As recently as December 2000, Congress increased annual Housing Credit authority by 40 percent. Over 85 percent of the Congress, with nearly equal proportions of Republicans and Democrats, cosponsored the legislation calling for that increase.

We offer a simple solution to the problem the dividend proposal presents the Housing Credit. Treat Housing Credits as taxes paid, as the proposal treats foreign tax credits.

We look forward to your help in protecting this vital supplier of the nation's affordable rental housing. We stand ready to assist you in any way we can. If you have questions about the Housing Credit or the Ernst & Young report, please do not hesitate to call me.

Sincerely,

Barbara J. Thompson
Executive Director

Enclosure
cc. Assistant Secretary Pamela Olson
Deputy Assistant Secretary Gregory Jenner

Mr. NEAL. Thank you, Mr. Chairman. Mr. Houghton and I have worked hard on this. In fact, we have had legislation pass Congress

that succeeded, with the help of the Chairman, on that whole notion of extending bond opportunities.

Let me ask you, with some of the projections you are going to be making and some of the items that you might be focusing on, if these concerns are well-founded, and would you be recommending these investments over dividend-paying equities in the future?

Mr. GLASSMAN. You know, real estate has always been tax advantaged or at least for decades, and I think that certainly real estate interests are not happy about the fact that equities, which have been tax disadvantaged, are now going to have an even playing field. So certainly that equation changes, but would I tell people not to invest in real estate? Absolutely, I would not tell people not to invest in real estate. I think that is a good part of a diversified portfolio, and real estate still enjoys, even after these changes, far more advantages than any other kind of investment that people can make.

Mr. NEAL. Quickly, Mr. Chairman? Mr. Gale, would you argue that by not addressing the AMT issue that some people are about to get a tax increase?

Mr. GALE. We might get a little metaphysical about what a tax increase is versus not getting a tax cut, but it is clear that many people starting in 2005 and under current law, will face higher taxes under current law than they would if the AMT didn't exist. By the end of the decade, it will be 36 million households that will face higher taxes because of the AMT.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman THOMAS. I would tell the gentleman that you would have to analyze that in the face of the so-called hold harmless provision on the AMT that is in this package and, in fact, has been in every package that we have looked at.

Mr. GALE. That only goes to 2005.

Chairman THOMAS. I understand. It is temporary.

Mr. NEAL. Mr. Chairman, could I have permission to insert into the record a statement from a number of leading economists opposing the tax cuts?

Chairman THOMAS. Certainly, without objection. Does the gentleman from Pennsylvania, Mr. English, wish to inquire?

[The information follows:]

ECONOMISTS' STATEMENT OPPOSING THE BUSH TAX CUTS

Economic growth, though positive, has not been sufficient to generate jobs and prevent unemployment from rising. In fact, there are now more than two million fewer private sector jobs than at the start of the current recession. Overcapacity, corporate scandals, and uncertainty have and will continue to weigh down the economy.

The tax cut plan proposed by President Bush is not the answer to these problems. Regardless of how one views the specifics of the Bush plan, there is wide agreement that its purpose is a permanent change in the tax structure and not the creation of jobs and growth in the near-term. The permanent dividend tax cut, in particular, is not credible as a short-term stimulus. As tax reform, the dividend tax cut is misdirected in that it targets individuals rather than corporations, is overly complex, and could be, but is not, part of a revenue-neutral tax reform effort.

Passing these tax cuts will worsen the long-term budget outlook, adding to the nation's projected chronic deficits. This fiscal deterioration will reduce the capacity of the government to finance Social Security and Medicare benefits as well as investments in schools, health, infrastructure, and basic research. Moreover, the proposed tax cuts will generate further inequalities in after-tax income.

To be effective, a stimulus plan should rely on immediate but temporary spending and tax measures to expand demand, and it should also rely on immediate but temporary incentives for investment. Such a stimulus plan would spur growth and jobs in the short term without exacerbating the long-term budget outlook.

George Akerlof*
UNIVERSITY OF CALIFORNIA-BERKELEY
Lawrence Mishel
ECONOMIC POLICY INSTITUTE
Laura D'Andrea Tyson
LONDON BUSINESS SCHOOL
Kenneth J. Arrow*
STANFORD UNIVERSITY
Franco Modigliani*
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Douglass C. North*
WASHINGTON UNIVERSITY
Lawrence R. Klein*
UNIVERSITY OF PENNSYLVANIA
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MASSACHUSETTS INSTITUTE OF TECHNOLOGY
William F. Sharpe*
STANFORD UNIVERSITY
Daniel L. McFadden*
UNIVERSITY OF CALIFORNIA–BERKELEY
Joseph Stiglitz*
COLUMBIA UNIVERSITY

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Mr. ENGLISH. I do, indeed, Mr. Chairman. Thank you, Mr. Gale. I would like to perhaps move this from the metaphysical to something a little more concrete, but to build on a line of questioning just pursued by my colleague from Massachusetts with Mr. Glassman.

As I understand it, not paying corporate taxes, by your definition sheltering income, one way to reduce tax liability is to utilize provisions in the tax code, such as the low-income housing tax credit or the wind energy tax credit. Is it your testimony today that the President's dividend proposal will not "reduce to a significant degree" the use of tax shelters such as low-income housing tax credits and wind energy tax credits?

Mr. GALE. There are two issues with the use of sheltering, and it depends on whether the shareholder is taxable or tax exempt. I have written a paper that showed that half of dividends accrue to shareholders that would not be affected by the change in the dividend tax treatment.

Mr. ENGLISH. On page 6 of your testimony, you said that "The Administration's proposal would have no effect on firms' incentives to shelter and retain earnings. The proposal, therefore, does not eliminate, and may not even reduce to a significant degree, the incentives that exist under the current tax system to shelter corporate income from taxation and then to retain the earnings."

Am I reading that correctly?

Mr. GALE. You left out one part, which is, "The Administration's proposal would have no effect on firms' incentives to shelter and retain earnings to the extent that firms are owned by nontaxable shareholders."

Mr. ENGLISH. I see.

Mr. GALE. So, for them, there is no net effect. To the extent that firms are held by taxable shareholders, the Administration's proposal would reduce incentives to shelter somewhat, but it is also true that firms could still maximize the after-tax return by sheltering the corporate income from taxation and then retaining the earnings.

Mr. ENGLISH. That is very nuanced testimony, and I think that is a good counterpoint to some of the panic we have heard from some of the opponents of this provision on that point.

Mr. Gale, in listening to your testimony earlier, I believe you said that the most efficient thing we could do would be to take Federal dollars and provide them back to the States as a stimulus.

Is it your view that State and local governments inherently spend resources more efficiently than the Federal Government?

Mr. GALE. I think that when I used "efficiently" there, I meant it in the terms of the cost to the Federal Treasury relative to the boost to the economy. So the issue isn't the efficiency of the State

government versus the Federal Government, it is that a dollar that flowed from Federal to State coffers would be a direct-stimulus effect, would have a direct-stimulus effect.

Mr. ENGLISH. What if local governments and State governments took the Federal dollars and raised taxes anyway?

Mr. GALE. No, no. What the Federal money would do would be to allow them not to raise taxes in a situation where they otherwise needed to raise taxes, the idea being——

Mr. ENGLISH. That is true. As someone who actually has had a career in State government, and who was a finance officer in local government, that is not the way State and local governments all too often behave, unfortunately, and that may be a political component that your model is not addressing.

Mr. Glassman, you raised a very important point about how the President's proposal on dividends will improve the transparency of corporate finance. Could you elaborate on why you think this could be a significant corporate governance reform in addition to tax policy.

Mr. GLASSMAN. In fact, I think it is the most important corporate governance reform. A year ago I testified in front of the Financial Services Committee, and I said if you really want to do something about corporate governance, and I realize this is not what the Financial Services Committee is supposed to do, but eliminate the double taxation of dividends, and the reason is this:

That corporations today have very little incentive to pay dividends to their shareholders, so they have cut back on dividends, they have cut back on the percentage of profits that they pay. Dividends have become, in many cases, practically meaningless, so that an individual investor cannot look at a dividend and say, "Oh, here is a company that is consistently increasing its dividend. That is the kind of company I want to invest in."

There are too many mixed messages being sent because of the interference of the tax law. If you eliminate double taxation, investors can come to rely on that dividend figure. A lot of academic research has shown that companies are very reluctant to cut their dividend, and when you see a dividend payout, that is a more reliable figure in many cases, I would say in most cases, than the paper profits that a company is declaring to the Securities and Exchange Commission, which, as we know, can easily be manipulated.

You can't manipulate cash or you might be able to do it one or 2 years, but you can't do it over the long term, and it is very transparent. It is very clear. So I think it would add tremendously to the average investor's perception of what is happening.

Mr. ENGLISH. My time has expired, but I want to thank all three of you gentlemen for excellent testimony today, which I think substantially enhances our understanding of the subject matter. Thank you, Mr. Chairman.

Chairman THOMAS. Thank the gentleman. Does the gentleman from Kentucky, Mr. Lewis, wish to inquire?

Mr. LEWIS OF KENTUCKY. Yes, thank you, Mr. Chairman. Mr. Glassman, you stated a little while ago that 5 percent pay 56 percent of the taxes and 50 percent pay 4 percent; is that correct?

Mr. GLASSMAN. Yes, sir.

Mr. LEWIS OF KENTUCKY. We have had this debate for several years now. This has been a class warfare debate.

With 56 percent of the taxes being paid by 5 percent, it seems to me it makes all the sense in the world to try to encourage and to stimulate long-term growth in the sector of the economy that pays the most taxes, where jobs are created, where that those that need help within our society, those that, because of no fault of their own cannot help themselves, that a huge proportion of the taxes being paid by the upper 5 percent go to help those that can least help themselves; is that correct?

Mr. GLASSMAN. Yes, I agree with that, Congressman. I do think it is important that society pay attention to and not overburden and help the less fortunate, the lower earners. I think we are doing a good of that, and maybe we could do a better job, but in general, absolutely, that by taxing higher earners, people get hurt in the lower levels, get hurt in the sense that they don't have jobs.

Mr. LEWIS OF KENTUCKY. Absolutely. If we can't get the economy moving in the right direction, again, and I think you would agree with me that the reason we are in the huge deficits that we are seeing, even though it is 2 percent of the gross national product, is because of a slow-down in our economy.

Mr. GLASSMAN. Absolutely. There is no doubt about that. Revenues have slowed down dramatically as a result of what has happened in the stock market and the decline in growth.

Mr. LEWIS OF KENTUCKY. So if we can create jobs, and I want to use my son and daughter-in-law as an example, they are factory workers. They have an average income of probably, I don't know, $50- to $60,000 for both of them, combined. They work for an automobile parts manufacturer. Now, how much are they paying in income taxes every year, on average?

Mr. GLASSMAN. Probably, actually——

Mr. LEWIS OF KENTUCKY. They have a daughter. They have one——

Mr. GLASSMAN. Actually, I used an example that is quite similar. If they are making $60,000, I believe they are paying about $3,000 in income taxes or $3,500 in income taxes a year.

Mr. LEWIS OF KENTUCKY. Okay.

Mr. GLASSMAN. I think that is about right.

Mr. LEWIS OF KENTUCKY. They are very interested in keeping their jobs, and if the automobile industry is not selling automobiles, if there is a slowdown there, then they very well could end up in the unemployment line. I could tell you they certainly would prefer a weekly wage to an unemployment check.

Mr. GLASSMAN. I think that is the problem. If I could just comment, one of the things that Mr. Gale said about States, he said that States are bringing the economy down by raising taxes and cutting spending. I think there are very few economists who would disagree with the notion that when you are in tough times, the last thing you want to do is raise taxes and, in fact, one of the first things you want to do is to cut taxes. So, absolutely.

Mr. LEWIS OF KENTUCKY. Well, isn't it true that the average family, with the Federal tax burden, the local, State tax burden, they are paying about 50 percent of their income—40 percent—in local, State and Federal taxes, and then when you add in the regu-

latory burden of government, then you are getting into a significant amount of their income. Is that true?

Mr. GLASSMAN. Yes, sir.

Mr. LEWIS OF KENTUCKY. So I think we need some tax relief, don't you?

Mr. GLASSMAN. Yes, sir.

Mr. LEWIS OF KENTUCKY. Thank you.

Chairman THOMAS. Thank the gentleman. Does the gentleman from Tennessee, Mr. Tanner, wish to inquire?

Mr. TANNER. Thank you very much, Mr. Chairman. I, too, would like to thank the panel. I think it has been a very interesting discussion, one that I have enjoyed and I think benefited from, as I hope the other Members have.

I want to ask a question about deficits, and debt, and carrying charges, I call them, for lack of a better term. According to the latest figures, last year we either accrued or paid interest of about $330-some-odd-billion on an income of $1.8 trillion. That works out to be 17 or 18 percent of our income was paid or accrued to trust funds as interest on the national debt.

Is there a point or what, in your opinion, what is the point at which this interest rate that the country is paying every year on the national debt, no matter what it is, in terms of debt, at what point does that restrict or impede the government's ability to make the necessary investments in public infrastructure so that private enterprise can flourish, and expand, and grow, and create jobs? Is it 20, 25, 30 percent? Mr. Glassman, in your opinion, at what point does this interest rate on present income that we are paying become too burdensome to carry?

Mr. GLASSMAN. Congressman, I really don't know what the answer to that is. I think that where we are now——

Mr. TANNER. Is it closer to 50 or 30?

Mr. GLASSMAN. It may be 50. It is a complicated issue in the sense that this interest, most of it, is being paid to Americans themselves who will then take the money and do other things with it, maybe invest in stocks, maybe invest further in bonds.

The real question I think is, as long as we have debt levels at the level that we have today, which is about maybe one-third of GDP for the public, for the debt owed to the public, which I don't think is onerous, the real question is what are we using that debt for, which is to say are we spending the money on the right things?

I think at these levels we are not in kind of a dangerous economic circumstance.

Mr. TANNER. I think you know about a trillion-and-a-half of this debt that we actually pay, write checks on, is held by foreigners.

Mr. GLASSMAN. Some of it is held by foreigners, correct.

Mr. TANNER. Yes, about a third. Would you care to comment about this interest that we are paying out of present income with regard to our ability to invest in those things?

Mr. CASTELLANI. I am going to pass. I do not know the answer to that.

Mr. GALE. I can't give you a specific number either, but I do want to emphasize that our debt-to-GDP ratio, if you just look at the debt held by the public, is an extraordinarily misleading figure

because it omits all of the liabilities due in Social Security and Medicare. It astounds me that people who analyze firms very carefully and look for all of the footnotes in the documents and try to get the exact right measure of the financial picture of the firm, at the same time completely ignore the 800-pound gorilla of implicit debt when it comes to looking at the Federal Government.

The Federal Government is in debt up to its ears, but not all of that debt has a U.S. bond written on it or a Treasury bill. A lot of it is implicit in the form of the promises we have made to Social Security and Medicare, and to argue that our current debt position is trivial or manageable ignores all of that.

Mr. TANNER. What we would call contingent liabilities are not contingent, really, but future.

I did some figuring here, and by my figures there are 129 million individual taxpayers in the country. If you divide that into the interest paid last year, on average—and that seems to be what everybody is talking about—every individual taxpayer last year, when they filed their income tax return, paid $2,556 as their share of the interest on the national debt for last year. I call that a debt tax, not a death tax, but a debt tax.

If one believes in the figures that we see, and the projections that are being paid about deficits as far as the eye can see, it seems to me that this number is going to have to go up because interest on the debt is the one tax increase that I know of that cannot be repealed. Now, you are talking about real dollars. You can talk about percentage of GDP on everything else, but when you start talking about money that people pay, it seems to me the debt is quite real.

Did any of you have a comment on that?

Mr. GLASSMAN. I think, again, Congressman, you have to look at what that money is being paid for. We have a big government. We have got $2-trillion budgets, and that money is being paid as interest on what a lot of people consider to be investments that this country has made in defense, in welfare, in education and all of the kinds of things that—goods and services that Governments buy.

The real question is, is it worth it? I think that is a question that you need to ask, as Members of Congress, over and over and over again. Quite frankly, I don't think those questions have been asked much in the past.

There are only two ways to pay for it, as I said—either debt or taxes—and both methods pull money out of the private sector, have the same effect.

Mr. TANNER. I couldn't agree with you more, and I think some of the proposals, for example, the debt being advantaged in the Code over equity is not a good situation in the Tax Code, and I like that.

You made a startling statement when you said we are spending very little on the debt, Mr. Glassman. If we are spending 17 cents out of every dollar that comes here in interest this year, it seems to me that one could make the argument we have got a 17-percent mortgage on this country. I think if you equate that to a business, that is quite high, regardless of what it is being spent on, because this interest is being basically spent not on investment in public in-

frastructure that allows private enterprise to grow and expand, in my view. Thank you.

Chairman THOMAS. I thank the gentleman. The gentleman's time has expired. Does the gentleman from Texas, Mr. Brady, wish to inquire?

Mr. BRADY. Yes, thank you, Mr. Chairman. Thank you for being here today to all of the panelists.

Debt is important, but common sense tells you that if you don't have a job, you are not paying much into the Federal Treasury to pay down that debt. If businesses are going under and not creating jobs or don't have a profit, you are not doing much else to generate revenue and pay down this debt.

So common sense, I think, is pretty clear. The best way we can balance the budget, pay down the debt and have the revenue to preserve Social Security, Medicare, and our other issues is to get the economy going, and I think that is what the testimony today is focused on.

There is also, some intangibles to this tax relief. On the dividend proposal—and this is what I wanted to ask you first, Mr. Castellani, and the other panelists if you would like—is that our Tax Code changes people's behaviors, and they do things differently because the Code, and it is the same way for business.

You have many, many business members of all shapes and sizes and different types of products, and as you look at the dividend proposal, in addition to helping seniors who are the biggest holder of these dividends, in addition to the transparency, in what way do you think the dividend proposal changes behaviors for business that would help a family try to restore their stock portfolio, help them rebuild their retirement nest egg for the future? What behaviors occur that would help me or my family or my neighbor's family help benefit in this process?

Mr. CASTELLANI. Well, there are three significant changes in behavior that I think would come as a result of this proposal if it were enacted.

First and foremost, because it does eliminate the penalty that is now imposed on paying dividends, you will increase dividend payout rates. So if you own a share, if you don't buy another share, if it is in your savings plan, if it is in your possession, you will get more dividend income as a result of this being enacted because it does eliminate that disincentive to pay out dividends.

Second, it will affect the cost of capital for a corporation. It should lower the cost of capital, and that lowering of the cost of capital is significant. By lowering cost of capital, by increasing economic activity, we believe that this will also increase economic activity by the corporation, so it will stimulate investment, it will stimulate certainly the creation of jobs. It, in of itself, is the largest single impact of all of the provisions in H.R. 2 and what the President has proposed in job creation.

Second, if you have that job, and you have those savings, it also helps substantially in the competitiveness of U.S. corporations compared to our foreign competitors. So that job that you have, the savings and the income that you will be able to generate from that, will be better enhanced because we will be able to be competitive, even more so than we are now.

We have among the highest tax rates for dividend income in the world, and that is a disadvantage for U.S. corporations. So I think there would be a significant advantage in all three areas.

Mr. BRADY. Does this, again, to any of the panelists, for those of us who are looking to invest not in companies that are pumping their stock, carrying huge debt, instead of choosing a long, steady, stable growth that my family is looking for, does this reinforce and encourage companies to take the short-term, get-rich approach or the long-term, stable, create jobs, be there 10 years from now approach?

Mr. CASTELLANI. It definitely emphasizes long-term stable growth and the production of dividends as cash, which Jim had said earlier that there are a lot of things you can do, and there are a lot of complexities with financial statements because these are complex organizations, but there are only two ways to generate cash, and one of them is counterfeiting and that won't happen.

The generation of cash will provide, we believe, for stable prices, for equities, increased prices for equities, and higher total shareholder return, as well as positive benefits for corporate governance.

Mr. BRADY. Great.

Mr. GALE. I actually disagree with a few of the things that were just said.

One is I think the emphasis on short-term performance is not driven by the firm, it is driven by the investors, and as long as investors have that desire, either firms will respond to it or investors will respond in certain ways that make firms respond to it.

Mr. BRADY. I don't mean to interrupt, but don't you really have a choice? As an investor, I can go for a technology company or someone who is moving their stock price up or a more stable company that prefers to pay me back some revenue each year. Is that right?

Mr. GALE. That is right, and what will happen is that there will be tax-exempt shareholders and taxable shareholders, and there will be a lot of activity once a corporate return is filed. Tax-exempt shareholders selling their stocks to taxable shareholders who then take the money out and sell at a capital loss would be one example of a shelter that would be created.

There is a whole little cottage industry going on in the tax world about new ways to shelter money under this proposal, and I can refer you to a couple of articles on that.

Mr. BRADY. Thank you, Mr. Chairman.

Chairman THOMAS. The gentleman's time has expired. Does the gentleman from Illinois, Mr. Weller, wish to inquire?

Mr. WELLER. Thank you, Mr. Chairman. For the gentlemen on the panel, thank you for your patience and participation this afternoon in what has been I believe a good panel.

Of course, I think the goal for all of us in the room is to give Americans who currently are not working the opportunity to go back to work. That is the bottom line and what I know the President wants to achieve, and I think we and the Congress want to achieve as well to get this economy moving again.

I represent the South suburbs in the Chicago area, a lot of manufacturing, a lot of petro chemicals, a lot of agriculture-, and transportation- and manufacturing-type enterprises there. As I talk

with workers, as I talk with small business and entrepreneurs and taxpayers, whether blue collar or white collar, they like a lot of what the President has proposed.

They like the fact that there is an immediate benefit from making the rate reductions effective this year, rather than 10 years from now. Small business likes that, in particular.

They like the fact that 46-million married couples, who suffer the marriage tax penalty, will see full relief this year rather than at the end of the decade. Those with children like the fact that we are doubling the child tax credit from $600 to $1,000 and the fact that a check will be sent out shortly after this becomes a law.

They also like the fact that because the rate reductions will be effective immediately, the withholding will be adjusted within a paycheck or two. They will see higher take-home pay. So, for the average taxpayer in Illinois, an extra $1,000 in higher take-home pay is going to mean a lot in helping them meet the needs of their families. So they like those ideas.

The one proposal I would like to focus on is the President's plan where he talks about small business investment, the expensing portion of the President's plan. Economists have told me that for about every dollar in revenue impact to the Federal Treasury, there is about $9 in economic impact that comes from expensing.

We did some accelerated depreciation, a 30-percent accelerated depreciation in the stimulus package that went into law a year ago. The technology sector, manufacturers in my area told me that has had a positive impact. The technology sector says that 30-percent accelerated depreciation has brought them back to essentially where they were in the first quarter of 2001. They have seen a little bit of a recovery as a result of that, and John Deere and others have credited accelerated depreciation with an impact.

The President proposes targeting the expensing changes solely to small business, and that is good. The $25,000 to $75,000 I think encourages small business to buy a new pickup truck or a delivery vehicle or a new computer, telecommunications equipment. There are workers somewhere that produce that. That is going to create jobs.

One of the concerns that I hear, and that is, in my area, a lot of suburban and rural communities that I represent are small manufacturers. They tend to be family held, they have been there for several generations, they employ 2- to 300 people. They don't qualify as small businesses, but at the same time they like the idea of doing more in the area of expensing.

Mr. Glassman, I was wondering do you have some ideas, and perhaps, if we wanted to help the smaller manufacturers, how we would expand upon the President's proposal to include more businesses being able to participate in the expensing the President has offered?

Mr. GLASSMAN. Well, I think it should be expended.

I would like to see, in an ideal world, all businesses able to expense all legitimate investment. That would have a tremendously positive effect on investment. I think most economists, and I am not an economist, but most economists would agree with that. It may be very difficult to do politically.

So I guess my answer to your question is that the more that you can do to extend expensing of investment the better. Even at this particular time, when a lot of people feel that what we need is help on the consumer side, give the consumers more money, let them spend, I think that for the long term it really is the investment side, if we can think of it as two sides, that is important here and that we can remedy actually fairly easily by extending the expensing of investments.

Mr. WELLER. One of the things I have been told by some of the employers in my district is they have delayed replacing their equipment. The economy is a little soft, so they have delayed replacing their company car, and the pickup truck, delivery vehicles, telecommunications, machine tools, the office computer.

Mr. GLASSMAN. Right.

Mr. WELLER. Do you believe that if we expanded the expensing, that would stimulate them or encourage them to replace that equipment now?

Mr. GLASSMAN. Businesses don't make decisions solely because of the tax benefits, nor do we want them to. So there certainly are times when, and this may be one of those times, with an impending war, that businesses are saying, "I don't care what the tax benefits are, I am not going to buy five new trucks or make an investment in the plant."

I think we have to look beyond the immediate problems and toward the future, and I do believe that it is better for the economy to have businesses making innovative investments than not. We don't want to just think about today.

Mr. WELLER. Thank you, Mr. Chairman. I see my time has expired.

Chairman THOMAS. The gentleman's time has expired. Would the gentlewoman from Ohio, Ms. Tubbs Jones, wish to be the last inquirer on this panel?

Ms. TUBBS JONES. Of course, Mr. Chairman. You know I couldn't miss this opportunity. Thank you very much. Let me say hello, Mr. Glassman. I think we met when I was on Financial Services.

Mr. GLASSMAN. We had. You interrogated me very vigorously.

Ms. TUBBS JONES. Get ready. No. Let me, first of all, say I am just amazed, in sitting through the few hearings that I have had as a Member of the Committee on Ways and Means, particularly yesterday and last week the testimony of Secretary Snow and the testimony of Mr. Glassman and Mr. Castellani, that all of these things you say are not impacted by the fact that we are, according to Mr. Snow, not in a war, the President doesn't want to get in a war, but we have expensed millions or billions or trillions of dollars to be ready to go to war, and we are sitting on the verge about to jump off.

Let me go on to ask you a question. Did you, in fact, say, Mr. Glassman, that what counts is not what the government spends, but what it spends it on?

Mr. GLASSMAN. Yes.

Ms. TUBBS JONES. I would agree that most of the American public right now sitting out there, particularly those seniors who are questioning who is going to pay for a prescription drug benefit

would say that it is true, it doesn't matter what the government spends it on, what the government spends, but what it spends it on, that they think that we ought to be spending some of this money that we have on a prescription drug benefit, where they don't have to go into a health maintenance organization in order to receive a prescription drug benefit and that they have paid their dues—you know, like my folks who are 81, 82, 83 years old have paid their dues—and we ought to really be spending money on a prescription drug benefit. I guess that is a question for another day.

Let me ask you this. You did say one of you, Mr. Glassman, Mr. Castellani, that the Tax Code does change behavior, and the fact is that the Tax Code changes people's behavior. One of you said that; is that correct?

Mr. GLASSMAN. He said it, but I agree with it.

Ms. TUBBS JONES. You both agree with it.

Mr. GLASSMAN. I think Bill even agrees with it.

Ms. TUBBS JONES. We can tell that this is—I will leave that alone. In fact, the fact that the Tax Code provided a privilege or an incentive, that caused many people to invest in low-income housing over the past 10 years; is that a fact, Mr. Castellani and Mr. Glassman?

Mr. GLASSMAN. I am really not an expert in that area, but, clearly, there is a tax benefit, and so it would encourage that.

Ms. TUBBS JONES. You know I kind of figured that neither of you were experts in that area, and this is not to be offensive, but in neither of your statements did you talk about the impact that the dividend tax cut would have on low-income housing or the impact that it would have on qualified educational bonds. Those are dollars that are used as a tax shelter to build schools across the country, nor did you talk about in there anything about new markets initiatives or empowerment zones or enterprise zones—all of those programs which will be impacted by a dividend tax cut.

So since you all don't know much about that, I guess I will move on to some thing else.

Let me ask you, Mr. Gale, I am interested in your statement with regard to partial expensing and your position that it is unlikely to have a significant impact on small businesses doing greater business. Can you expand on that a little bit for me, sir?

Mr. GALE. Sure. Right now I think that there is a tremendous amount of uncertainty in the economy, a lot of it related to the situation in Iraq, a lot of it related to sort of just general economic uncertainty. I think that what Mr. Glassman said a couple minutes earlier is right, which is that right now, if you give them a bigger tax incentive, it is not going to do anything. That is not the reason they are not investing.

Ms. TUBBS JONES. Would you like to tell me, very briefly, seeing how we only have a couple minutes, in addition to the war in Iraq and the uncertainty and the anxiety, what is the reason people aren't investing?

Mr. GALE. That covers it. They are not investing because there is too much uncertainty I think right now surrounding things like war and oil prices.

Ms. TUBBS JONES. Assume, in the best of worlds, that—strike that. Go on and answer your question. I apologize.

Mr. GALE. So there are two other reasons why I don't think it would do much right now. One is because we have low capacity utilization rate, we would be asking firms to buy new equipment when they are not even using the equipment that they currently have. I believe this is what my colleague here was talking about earlier as well.

The third reason is that, remember, we have already got generous investment subsidies in place. We have got 30-percent partial expensing. We are seeing the effects of that right now. If you don't see anything because of that, I don't either, but we have more generous incentives than usual in place right now. So I think it will be——

Ms. TUBBS JONES. So just to that point, the United States is not such a terrible place to do business, is it?

Mr. GALE. No. Actually, the United States is a wonderful place to do business, and all of the discussion about how our tax rates are much higher than European countries is based on particular examples. If you look at the economy as a whole, our corporate tax burden is one of the lowest in the Organization of Economic Cooperation and Development (OECD), and the reason why is we have so much corporate income that is either not taxed at all or is only taxed once.

It is true that if you have corporate income that is taxed twice and the shareholder is the highest income bracket, there is high effective tax rate on it, but that applies to only a very small portion of total corporate income. So, yes, the United States is a good place to do business.

Ms. TUBBS JONES. Thanks, Mr. Chairman.

Chairman THOMAS. Thank you, and I want to thank the panel.

As a parting question, since all of you are very familiar with the Hill and the legislative process, if the primary concern is over the war with Iraq, whether we have a war or not, do you think that decision will be finalized prior to the tax legislation going to the President's desk?

Mr. GLASSMAN. I don't know. In some ways, I hope not, but I guess it will.

Chairman THOMAS. Well, if that is the uncertainty, and people aren't dealing with it by the time this is ready for signature, the Chair's assumption, based upon the pace of legislative progress, is that won't be an impediment one way or the other.

Mr. GLASSMAN. Could I add something, Mr. Chairman? I mean, this distinguished Committee is, its work, and you know this better than I, is supposed to be for the long term, and I think that certainly that should be your focus, whatever is happening in the next few weeks.

Mr. CASTELLANI. Mr. Chairman, I would just also add that national security and economic security are inexorably tied together, and both have to be pursued, and both are important and vital. We need both, and so I hope that the Committee can move expeditiously because we think the impact of this program is needed and is needed quickly in this year.

Chairman THOMAS. Mr. Gale, a final word?

Mr. GALE. Sure. I think that this is not the right solution in the short run, and it is not the right solution for the long run, and that is independent of what happens in Iraq.

Chairman THOMAS. The gentleman from New York wishes to——

Mr. RANGEL. I just want to ask, Mr. Castellani, if you were in my place, would you be interested at all in the projected cost of a war or would that just fold into our search for economic growth, and that is one of things—I mean, would this, if you had to review the budget, the tax cuts, the incentives, and the locking into place long-term economic growth, would it concern you at all if you were in place?

Mr. CASTELLANI. I think it is important that we understand, to the extent that we can every cost, just like your example before about the cost of a hurricane. Companies do that regularly to try to mitigate risk, but there are just some risks that you can't quantify when you would like to. I think it should be pursued, but I am not surprised that it can't be quantified.

Mr. RANGEL. Would the company be concerned about a hurricane that occurs—you know war is a hurricane every day.

Mr. CASTELLANI. I recognize how difficult it is to quantify it.

Mr. RANGEL. I wish you hadn't used the hurricane as an example because I really think it is much more serious than that.

Chairman THOMAS. The Chair wants to thank the panel once again. We did take an extended period of time, but we are pleased we focused on the tax rates, the child credit and the marriage penalty.

The next panel that will focus on dividends consists of the, as I said earlier, Honorable Frank Keating, American Council of Life Insurers, and I am sure we will get into the State and local Government question by virtue of his being the former Governor of Oklahoma; Mr. John Schaefer, representing Morgan Stanley and the SIA; Mr. Ronald Stack, Municipal Securities Division; and the Honorable Alan Hevesi, current New York State Comptroller, which means we are going to talk about conditions today.

I want to thank all of you for waiting. Some Members will come back. The Chair just wants to underscore the fact that the quality is here, if not the quantity, with the gentleman from New York and other Members.

When you settle in—the Chair will indicate that any written statement that you may have will be made a part of the record, and you can address us, and I do hope we can attempt to confine the remarks to the time available to you, and we will just start with the former Governor and move across the panel.

STATEMENT OF THE HONORABLE FRANK KEATING, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN COUNCIL OF LIFE INSURERS (FORMER GOVERNOR OF OKLAHOMA)

Mr. KEATING. Thank you, Mr. Chairman and Members of the Committee, for the opportunity to participate in these important hearings.

As head of the American Council of Life Insurers, I represent 383 life insurance companies whose products help families manage

risks that could be financially devastating. Our products help families accumulate savings for retirement, as well as manage savings during retirement, to provide a guaranteed income for life. They protect families from the financial devastation caused by an untimely death, disability and chronic long-term-care need.

The industry's $3.3 trillion in assets makes it the fourth largest institutional investor in the United States and the second largest among investors specifically geared toward long-term investment.

The Administration's goal, which we support, is to eliminate double taxation of dividends on stocks held individually or through mutual funds. To be consistent and fair to Americans saving for retirement, however, dividends credited to stock investments underlying an after-tax variable annuity contract should be accorded the same level of tax. An annuity transfers the responsibility and risk of money management from consumers to the insurance company. It encourages long-term savings for retirement and provides an income that can never be outlived, thus, ensuring real retirement security. In a recent survey, Mr. Chairman, 71 percent of voters supported Government tax incentives for retirees to obtain that guaranteed lifetime stream of income. Certainly, guaranteed annuity income streams should not be penalized through a double tax when other types of income bear only one level of tax.

The life insurance industry strongly supports tax proposals that seek to simplify the Code, lower rates, promote growth and the anti-competitive features of the corporate income tax and increase savings. We believe that a critical consideration should be the effect of any tax change on the ability of individuals to secure a sound financial future. This is especially critical now, as millions of baby boomers approach retirement age.

We urge the Congress to evaluate carefully the effect of any potential weakening of incentives for individuals to save specifically for their own retirement. As noted, America's personal savings rate has declined over the past decade from 5 percent annually to less than 1 percent. Americans are increasingly having longer retirement periods. Men and women who are 65 have an additional life expectancy of 16 and 19 years, respectively. Sixty-one percent of Americans are concerned about their retirement savings lasting as long as they live. When faced with near-term realities such as housing, education and day care, it is hard to save for long-term goals such as retirement that may be decades away.

By repealing some disincentives within the current tax system, such as the double taxation of corporate earnings, the tax system will encourage more savings. This is part of the equation. An equally crucial component of retirement security is the protection and management of savings, particularly as lifespans increase. Without sufficient private resources set aside specifically for retirement, death, longevity, disability and long-term care needs, many more people will become dependent on the government, particularly in their old age. Without providing incentives for people to take personal responsibility for these purposes, efforts to control the growth of government will fail because the government will have to increase taxes to support those who have not provided for themselves. One unintended, but very real, consequence could be the weakening of the Nation's private insurance system.

In short, we urge you to support a successful part of the economy that invests long term and provides products for Americans' long-term financial security. The life insurance industry is an essential source of capital, with $257 billion invested in the U.S. economy in this past year alone. The life industry is good for America, and any fundamental tax changes should seek to strengthen this vital sector of the economy.

I understand that Treasury Secretary Snow acknowledged and committed to work on our concerns regarding variable annuities in yesterday's hearings before the Committee. We appreciate that, and we also look forward to working with you, and the Secretary, in this regard.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Keating follows:]

Statement of the Honorable Frank Keating, President and Chief Executive Officer, American Council of Life Insurers (former Governor of Oklahoma)

Thank you, Mr. Chairman, for giving me the opportunity to participate in these important hearings. As head of the American Council of Life Insurers, I represent 383 life insurance companies. The products provided by the life insurance industry help families accumulate savings for retirement, as well as manage savings during retirement to provide a guaranteed income for life. They protect families from financial devastation caused by an untimely death, disability, and chronic long-term illness. The industry's $3.3 trillion in assets makes it the fourth largest institutional investor in the U.S., and the second largest among investors specifically geared toward long-term investment.

We fully support the President's efforts to open serious debate in this Committee about the need to promote new economic growth and provide an innovative approach to addressing the double taxation of corporate income in the current U.S. tax system.

We appreciate that such a fundamental change to the tax system is a very complex undertaking. We also appreciate that any comprehensive reform may ultimately require some balancing of competing considerations. The Administration's goal is to eliminate double taxation of dividends on stocks held individually or through mutual funds. We support this goal. To fully eliminate the double tax, dividends credited to stock investments underlying an after-tax variable annuity contract (and other after-tax products) should be accorded the same one level of tax.

The annuity is a unique product that encourages long-term saving for retirement and provides an income that can never be outlived, thus providing real retirement security. Well accepted conventional wisdom encourages individuals to invest in equities for long-term savings; the combination of equity investment with the guarantees that are part and parcel of annuities should be encouraged. We believe that this can be accomplished by including dividends credited to variable insurance products as part of the economic growth tax package. If you cannot predict how long you will live in retirement, it's hard to determine how much to save and how much you should withdraw annually from your savings so as not to outlive them. An annuity transfers the responsibility and risk of money management from consumers to the insurance company and guarantees a steady stream of income that cannot be outlived by the policyholder and his or her spouse. In a recent survey, 71 percent of voters supported government tax incentives for retirees to obtain a guaranteed stream of income. Certainly, annuity payments should not be penalized with a double tax when other types of income bear only one level of tax.

The Administration's tax proposals seek to accomplish many goals, including simplifying the Code, lowering tax rates, promoting growth, ending the anti-competitive features of the corporate income tax, and increasing savings. These are all laudable goals that the life insurance industry strongly supports. For life insurers and policyholders, a critical consideration is the effect of any tax changes on the ability of individuals to secure a sound financial future. This is especially critical now because of the significant demographic changes that will happen over the next 40 years as the baby boomers reach retirement age. We believe this should also be of considerable concern to Congress as it examines the possibilities for change.

Given the looming demographic changes in the United States, it is essential that private savings for retirement and private resources for protecting against the financial burdens of death, longevity, disability and long-term illness be strength-

ened. When faced with near-term realities—housing, education, and day care—many working Americans find it hard to save for long-term goals, such as retirement that may be decades away. That is why Congress has always given special tax incentives to products that promote long-term savings.

And long term is growing longer as Americans are increasingly experiencing longer and longer retirement periods. Today, men and women who are 65 have an additional life expectancy of 16 and 19 years, respectively. Sixty-one percent of Americans are concerned about making their retirement savings last as long as they live. A combination of a decrease in defined benefit plans and longer life spans will increase the importance of individual annuities as a source of income. Only an annuity can guarantee that an individual will receive income payments for as long as he or she lives.

Congress will encourage more savings by repealing some savings disincentives within the current system, such as the double taxation of corporate earnings. This is part of the equation. We must also ensure that annuities which provide a means for Americans to manage and protect their savings in retirement are not devastated under the Administration's tax proposal. Moreover, without sufficient private resources set-aside specifically for retirement, death, disability and long-term care needs, we will see a significant increase in the number of individuals and families that will become dependent on the government, particularly in their old age. Without sufficient savings for these purposes, efforts to control the growth of government spending will fail because the government will have to increase taxes to support those who have not provided for themselves.

We believe strongly that it is an important and legitimate role of government to use the tax system to encourage Americans to prepare for their own futures. Providing strong encouragement for individuals and families to take responsibility for their retirement and financial burdens of death, longevity, disability and long-term care will go a long way toward preventing uncontrolled growth of government expenditures, while ensuring more comfortable, more secure, and more independent families.

That is why we have long supported accelerating and making permanent, that the Portman-Cardin comprehensive retirement security reforms. We must also look beyond incentives to accumulate retirement savings and find ways to help Americans manage and protect their savings. We appreciate Administration and Congressional support for legislation that would create an above-the-line deduction for long-term care insurance premiums. The tax code should encourage Americans to prepare for their retirement and protect their savings from being wiped out by the potentially catastrophic costs of their long-term care needs. Americans also face the serious risk in retirement that they will outlive their assets. Guaranteed lifetime income payments from an annuity are the most effective way for an individual to ensure that his or her retirement savings will last a lifetime. As a result, we also believe that Congress should enact the Lifetime Annuity Payout legislation that will lower the high tax rates on lifetime income payments from individual annuities, and should remove barriers to lifetime income payments from pension plans.

Finally, as part of the Administration's economic growth proposal, all corporate dividends that fall within the definition of excludable dividend accounts will be tax-free, whether received by an individual or another corporation. This same treatment should apply to dividends received by insurance companies. The insurance company dividend treatment should not, be changed in a way that would further adversely affect the life insurance industry, and represent an explicit tax increase on insurance companies.

In short, we look forward to working with Congress and the Administration on behalf of an industry that invests long-term and offers products that provide for Americans' long-term financial security. We appreciate the work of Treasury Secretary Snow and Congress to make sure that dividends for annuities are treated the same as dividends for stock and mutual funds. The life insurance industry is an essential source of capital with $257 billion invested in the U.S. economy in the past year alone. The life insurance industry is good for America. Any significant tax changes should seek to strengthen, this vital sector of the economy.

Chairman THOMAS. Thank you very much. Mr. Schaefer?

STATEMENT OF JOHN H. SCHAEFER, PRESIDENT AND CHIEF OPERATING OFFICER, INDIVIDUAL INVESTOR GROUP, MORGAN STANLEY & COMPANY, NEW YORK, NEW YORK, AND CHAIRMAN OF THE BOARD, SECURITIES INDUSTRY ASSOCIATION

Mr. SCHAEFER. Mr. Chairman, Members of the Committee, my name is John Schaefer. I am President and Chief Operating Officer of Morgan Stanley's Individual Investor Group.

I am here today testifying as chairman of the board of the SIA, which I Chair this year. The SIA believes the Administration's proposal to eliminate the double taxation of dividends will enhance the long-term growth potential of the U.S. economy. It will promote job creation and higher wage growth, strengthen corporate governance and put the United States on a more equal footing with our major trading partners.

Current U.S. tax policy skews economic decisions by taxing corporate income more heavily than other forms of income. Taxes are imposed twice; first, when the income is earned and, second, when it is distributed as dividends. The total effective tax on corporate income from investments financed with equities can be as high as 60 percent, far in excess of tax rates imposed on other income.

The President's proposal would improve the efficiencies of the capital markets, by reducing the artificial bias in the current law to, on one hand, issue debt and also to retain earnings. Importantly, eliminating the double tax on equity-financed investments would bring U.S. tax policy more in line with our major trading partners. The United States has the second-highest dividend tax among the 30 OECD Nations. Twenty-seven of the thirty OECD countries have adopted one or more ways of alleviating the double tax.

All G7 countries, with the exception of the United States, provide protection against the double taxation of dividends. So whether competing at home or abroad, the double tax makes it more difficult for a U.S. company to compete successfully against foreign competitors.

The end of the double taxation of dividends would help move our tax system to one that taxes income only once. This, in turn, will promote savings and investment, will promote increased capital formation, job creation and economic expansion. We believe the increased economic activity would generate additional tax revenues that could offset a significant percentage of the tax revenues foregone by this aspect of the proposal.

The immediate impact of eliminating the tax on dividends would be an annual tax savings of approximately $30 billion, or three-tenths of 1 percent of the GDP. This savings would be distributed broadly and shared by more than the 50 percent of U.S. households that own stock.

Increased after-tax dividends would make equities more attractive to investors. A higher after-tax value of dividends would also increase the value of stocks. It has been estimated that the value of the equity market would increase by 5 to as much as 20 percent. This increase in equity value would provide further economic stimulus through the wealth effect. We all know that people tend to

spend more as their net worth increases. It is also clear that a rising stock market is a leading indicator of future economic growth.

Almost half of all savings from the dividend exclusion would go to taxpayers 65 years of age and older, thereby giving retirees additional cash to supplement their Social Security earnings and other retirement savings. The average annual tax savings for the 9.8 million seniors who receive dividends would be $936 per year.

Perhaps the greatest long-term benefit from the elimination of the double taxation of dividends would be the incentives for companies to return to principles of sound financial management. With half of American families invested in the market, nothing is more important to the securities industry than restoring the public's trust in the strongest capital market in the world.

From the standpoint of both shareholders and the health of our economy, companies should be encouraged to concentrate on cash earnings. Encouraging companies to pay dividends would give investors a clear signal of the true financial strength and credibility of a company's earnings reports. That is because dividends offer proof of real profits.

Since dividends serve as a stronger foundation for longer term value, companies that pay them will have fewer motives to artificially inflate profits just to cause temporary increases in their stock price. Perhaps most importantly, dividend-paying companies experience half the market-price volatility and half the rate of share turnover of nondividend-paying companies.

Mr. Chairman, SIA commends you again for holding this important hearing. We believe the President's proposal to exclude dividends from the individual income tax will help investors at a critical time. It will boost stock prices, increase capital investment, strengthen corporate governance, provide retirees with additional cash and increase U.S. competitiveness abroad.

Thank you.

[The prepared statement of Mr. Schaefer follows:]

Statement of John H. Schaefer, President and Chief Operating Officer, Individual Investor Group, Morgan Stanley & Company, New York, New York, and Chairman of the Board, Securities Industry Association

Mr. Chairman and members of the Committee, my name is John H. Schaefer, and I am President and Chief Operating Officer of Morgan Stanley & Co's Individual Investor Group. I am testifying today as Chairman of the Securities Industry Association ("SIA")*. I thank the Chairman and the Committee for the opportunity to present SIA's views on the potential economic consequences of the Administration's proposal to eliminate the double taxation of corporate dividends.

SIA strongly supports the proposal to eliminate the double taxation of corporate earnings. The elimination of the double tax on dividend income would enhance the long-term growth potential of the U.S. economy, promote job creation and higher wage growth, strengthen corporate governance, and put the United States on a more equal footing with our major trading partners.

Current tax policy encourages corporations to rely too heavily on debt rather than equity financing, because interest is deductible but dividends are not. The bias fa-

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*SIA brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker—dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. Collectively they employ more than 495,000 individuals, representing 97 percent of total employment in securities brokers and dealers. The U.S. securities industry manages the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2001, the industry generated $280 billion in U.S. revenue and $383 billion in global revenues.

voring debt over equity financing, for example, led many companies to take on high levels of debt that left them vulnerable to the economic downturn. The President's proposal would improve the performance of our economy by relieving numerous distortions caused by the current corporate tax regime, including the income tax code's general bias against savings and investment.

CURRENT TAX POLICY CREATES NUMEROUS DISTORTIONS

Corporate income from a newly equity-financed project is subject to two layers of federal income tax. First, when the corporation earns a profit it pays tax at rates as high as 35 percent. A second level of tax is imposed if the corporation pays dividends to its shareholders out of its after-tax income, at individual tax rates that range as high as 38.6 percent. The total effective tax on corporate income from investments financed with new share issues can be as high as 60 percent, far in excess of tax rates imposed on other types of income. Even if the corporation retains earnings, the maximum combined effective tax rate approaches 50 percent on the appreciation in stock value (arising from corporate earnings that are retained and reinvested in the firm).

Under current law, interest payments are deductible to the corporation. This policy encourages corporations to retain earnings rather than distribute them, and to issue debt rather than stock. In addition, the double taxation of dividends encourages artificial shifting by businesses and investors into entities that will not be taxable as corporations under the Internal Revenue Code. Such distortions raise the cost of capital for investment financed with new share issues. The President's proposal would improve the efficiency of the capital markets by reducing artificial biases in current law to retain earnings and to issue debt.

U.S. POLICY LAGS OUR MAJOR TRADING PARTNERS

Importantly, eliminating the double tax on equity-financed investments would bring United States tax policy more in line with our major trading partners. With the exception of the United States, all G–7 countries provide protection against the double tax on dividends. In addition, the United States has the second highest dividend tax rate among the 30 OECD nations. Twenty-seven of the 30 OECD countries have adopted one or more ways of alleviating the double tax. Whether competing at home or abroad, the double tax makes it more difficult for a U.S. company to compete successfully against a foreign competitor.

ELIMINATING DOUBLE TAXATION WOULD BENEFIT U.S. ECONOMY

The end of the double taxation of dividends would help move our tax system to one that taxes income only once. This, in turn, promotes savings and investment, increased capital formation, job creation, and economic expansion. The increased economic activity would generate additional tax revenues that could offset a significant percentage of the tax revenues foregone by the proposal.

The immediate impact of eliminating the tax on dividends would be an annual tax savings of approximately $30 billion, or 3 percent of GDP. This savings would be distributed broadly and shared by the more than 50 percent of U.S. households that own stock. Moreover, in the case of the tax cut on dividends, there are additional factors that would help boost the economy in the long run. Because the after-tax value of dividends would increase, investment in stocks would become more attractive. It has been estimated that the value of the equity market would increase by as much as 5–10 percent. This increase in equity values would provide further economic stimulus through the wealth effect (people spend more as their net worth increases). It is no accident that a rising stock market is a leading indicator of economic growth.

The initial approximately $30 billion in tax savings is actually a very conservative estimate because it assumes no change in the current dividend policies of U.S. companies. But it is likely that more companies would issue dividends. Now that a tax cut on dividends has been proposed, companies that have previously retained large amounts of cash have said they may distribute some of that cash to shareholders.

As useful as a tax cut on dividends would be in reviving the current sluggish economy, the main benefits would be long term. The double taxation of corporate earnings reduces companies' return on capital and therefore increases the cost of capital. Lowering the cost of capital by eliminating taxes on dividends would encourage companies to invest more in plants, equipment and other capital stock, enhancing long-term growth and leading to more jobs and higher wages.

DIVIDENDS BENEFIT TAXPAYERS ACROSS THE INCOME SPECTRUM

According to the most recent IRS data, 34.1 million tax returns (or 26.4 percent of total tax returns, representing 71 million people) reported some dividend income in 2000. Of all taxpayers that claimed some dividend income in 2000, nearly half

(45.8 percent) earned less than $50,000 in adjusted gross income (including dividends). This proposal would also benefit more than 13.1 million small-business owners or self-employed taxpayers.

Importantly, almost half of all savings from the dividend exclusion would go to taxpayers 65 and older, thereby giving retirees an additional reliable, long-term source of income to supplement their social security earnings and other retirement savings. The average annual tax savings for the 9.8 million seniors receiving dividends would be $936.

IMPROVING CORPORATE GOVERNANCE WILL BOOST INVESTOR CONFIDENCE

Perhaps the greatest long-term benefit from the elimination of the double taxation of dividends would be the incentives for companies to return to the principles of sound financial management. With half of American families invested in the market, nothing is more important to the securities industry than restoring the public's trust in the strongest capital markets in the world. While we cannot blame the bubble of the late 1990s and its painful aftermath on the tax system, the current system did little to reign in the excesses and in some cases contributed to them. From the standpoint of both shareholders and the health of our economy, companies should be encouraged to concentrate on real earnings.

In that vein, encouraging companies to pay dividends would limit excesses because dividends offer proof of real profits. The payment of dividends by a company may give investors a strong signal of the company's underlying financial health and profitability. Indeed, a firm cannot pay dividends for any length of time unless the company has the earnings to support such payments. In an environment where reported earnings are viewed with some skepticism, cash dividends will bolster the credibility of earnings reports. Moreover, the payment of dividends would better align the interests of shareholders and managers by allowing shareholders to participate in decisions regarding corporate investment. Finally, because dividends serve as a stronger foundation for long-term value, companies that pay them will have fewer motives to artificially inflate profits just to cause temporary increases in stock prices.

CONCLUSION

Mr. Chairman, SIA commends you again for holding a hearing to review the potential economic consequences of a tax system in which corporate earnings are taxed only once. We believe the President's proposals will help restore investor confidence by increasing jobs, expanding the economy, and providing economic security to Americans. The proposal to exclude dividends from the individual income tax will help investors, boost stock prices, increase capital investment, strengthen corporate governance, provide retirees an additional reliable, long-term source of income, and put the United States on a more equal footing with our major trading partners. Thank you for allowing me to share the securities industry's views on this vitally important subject.

DEFENDING THE DIVIDEND

by Frank A. Fernandez

Excerpt from *Research Reports,* Vol. IV, No. 1 (January 31, 2003)

President Bush has proposed ending the double taxation of corporate earnings. To support that worthy goal, this article presents an assessment of the absolute and relative costs and benefits of this significant change in our tax structure. We consider to what degree the specific proposal encourages efficient capital formation, the growth of productivity as well as contributing to long run fiscal stability and moving the tax system towards fundamental reform, such as elimination of distortions and biases. On balance, the benefits of the proposal outweigh the costs.

SUMMARY

President Bush has proposed ending the double taxation of corporate earnings by eliminating the personal income tax on dividends. To support that worthy goal, an assessment of the absolute and relative costs and benefits of this significant change in our tax structure is presented below. We consider how the specific proposal encourages efficient capital formation, the growth of productivity as well as contributing to long run fiscal stability and moving the tax system towards fundamental reform, such as elimination of distortions and biases. On balance, the benefits of the

proposal outweigh the costs in terms of reduced tax revenues and less stimulus of consumption.

The benefits of this change, although gradual, are sustained, providing long-term support for economic growth by encouraging savings and investment, reducing the cost of equity financing, improving corporate profitability (a greater proportion of which would likely flow to shareholders) and boosting share prices. More efficient use of resources, enhanced productivity and higher incomes are some of the expected indirect benefits. By removing the bias that encourages companies to become more highly leveraged and hence more prone to failure, the proposal would also help contain record bankruptcy rates and reduce the sustained, near-record volatility in asset prices seen in recent years.

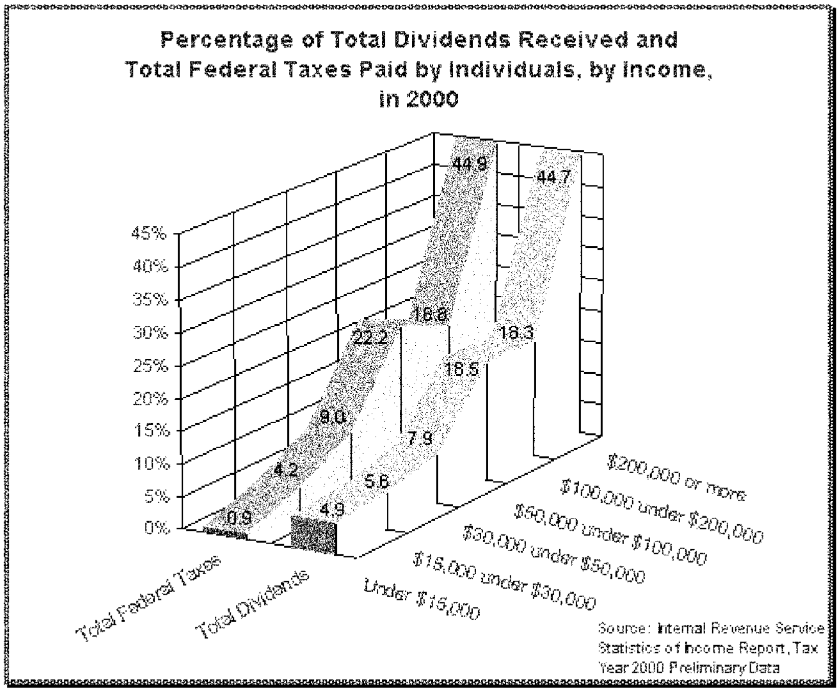
Eliminating the double taxation of dividends would also contribute to efforts to improve corporate governance. Achieving this goal would help restore public trust and confidence, a necessity if sustained economic growth is to ensue. The proposed tax change is expected to lead to: more accurate financial statements; less use of relatively opaque, noncorporate business structures (S-corps, L.P.s, sole proprietors and non-profits, which current tax rules favor over corporate forms); reduced opportunities and incentives for corporate managers to "game the system" (engage in transactions solely to reduce tax liabilities) or to mismanage; and, better alignment of management objectives with shareholder interests. It will encourage managers to focus more on the continuous, profitable operation of a firm, and less on activities that produce often transient stock price appreciation, and to undertake only the most productive investments rather than purchases that do not necessarily increase shareholder value.

Direct Benefits

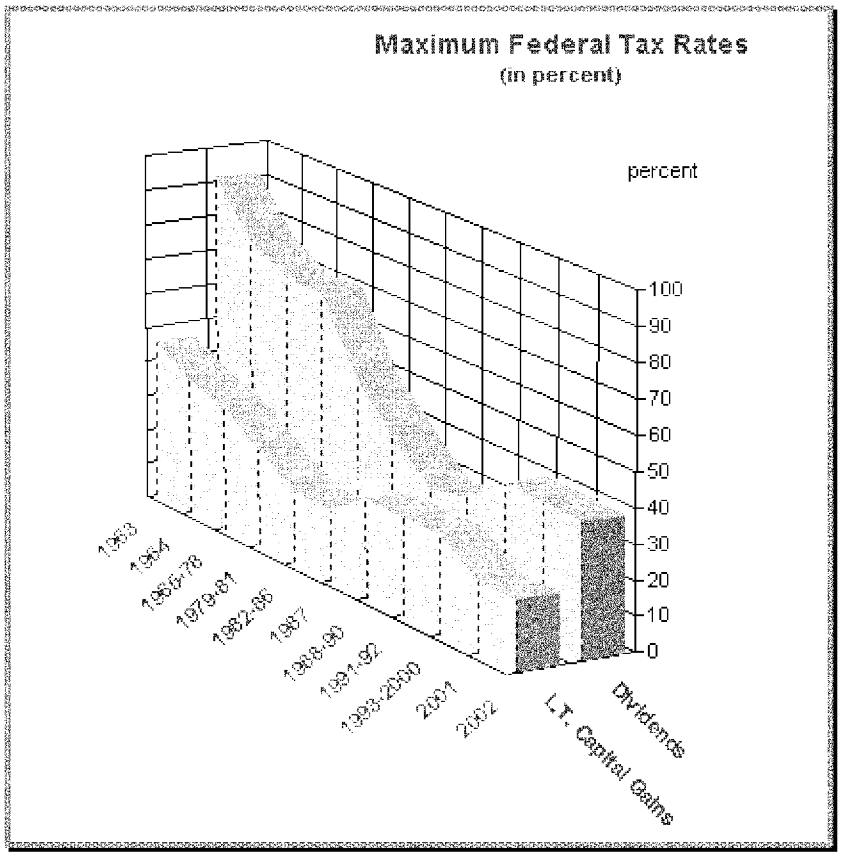
Everyone will benefit to varying degrees, either directly or indirectly, from the elimination of tax biases that distort corporate and investor decisions, and from the increase in incentives to save and invest. The proposal would benefit the economy (boosting incomes and job growth), the capital markets, and most of all, individual taxpayers, particularly those who invest, to whom the direct benefits flow.

Individuals, rather than corporations, are the direct beneficiaries, and the proposal would reward those who save and invest. Half of all American households (more than 84 million individual investors) own stock directly or through stock mutual funds, and are likely to benefit from the tax cut and the support to equity prices provided by this more neutral tax policy. Stock ownership, and the percentage of those receiving dividends, is expected to rise as this bias against dividend income is removed.

More than 34 million American households (26.4% of the 129.3 million households that filed returns in 2000) that invest in the stock market and receive taxable dividend income will benefit directly, and more than half these dividends go to America's seniors. 15.6 million or 45.7% of these households receiving dividends have adjusted gross income of $50,000 or less. Although this lower income group receives only 16.8% of the value of dividends distributed, this is slightly higher than the percentage of taxes that group pays, and the majority of people in that group are seniors.



Overall, the benefits of this tax proposal are largely neutral, in that they are distributed across income groups proportionate to the share of taxes they pay. Dividend recipients tend to be older, relatively wealthier Americans (similar to overall stock ownership patterns), many of them retirees, and many of those dependent on fixed income in part derived from dividends. This is similar to the distribution of tax payments relative to age and income as seen above.



The Current Tax Treatment

Under current law, corporate earnings are subject to two levels of tax: one at the corporate level and one at the shareholder level. Income earned by a corporation is taxed, generally at the rate of 35 percent. If the corporation distributes its after-tax earnings to shareholders in the form of dividends, this dividend income is generally taxed again at the shareholder level at rates as high as 38.6 percent.[1] The combined or effective tax rate on dividends can be as high as 60.1 percent. Alternatively, shareholders pay tax when they realize an appreciation in stock value that arises from retained corporate earnings, rather than earnings paid out as dividends, and reinvested in the corporation at a maximum tax rate of 20 percent.[2] The effective tax rate on income received this way is about 40.9 percent, taking into account the preferential tax rate on capital gains realizations and the benefits of tax deferral.[3] The President's proposal would equalize the effective tax rates confronted by

[1] There is no specific "dividend tax" applied to receipt of dividend income, unlike the separate calculation applied to capital gains. Dividends, along with income from pensions, interest, alimony, salaries and wages are added together and deductions are netted in the calculation of adjusted gross income on individual tax returns. The rate of 38.6 percent is the maximum statutory rate on individual income.

[2] The statutory tax rate on long-term capital gains held for more than five years is 18 percent, but taxes are deferred until the asset is sold, thereby lowering the effective rate on tax on capital gains. Taxpayers who hold assets until death receive a step-up of basis, and further reduce the effective rate.

[3] Council of Economic Advisers, "Eliminating the Double Tax on Corporate Income", January 7, 2003, p. 3.

investors receiving four principal types of income: dividends, retained earnings, debt and pass-through income.

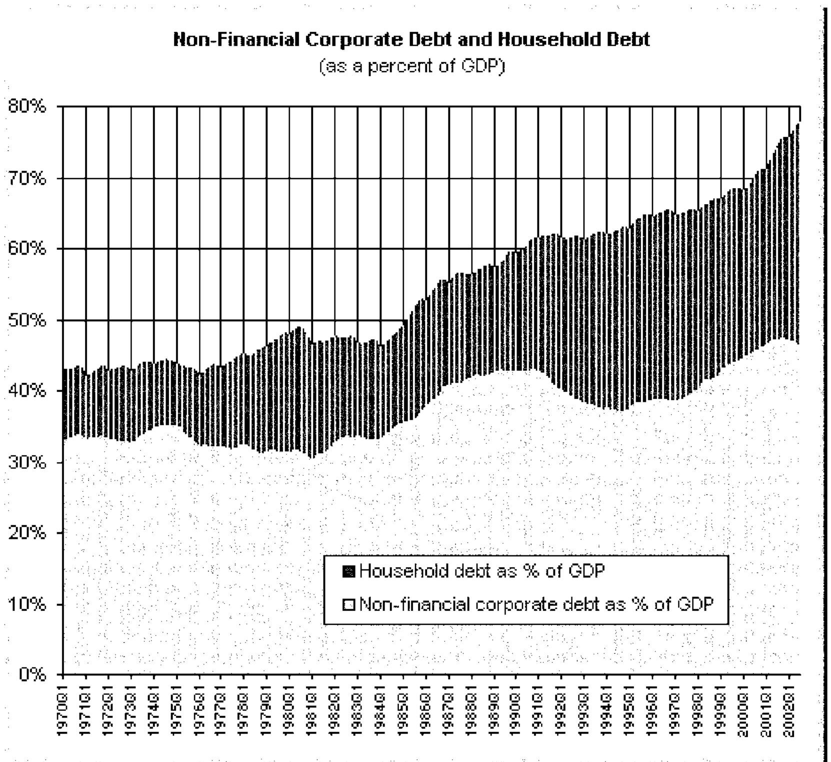
Presidents since John Kennedy have proposed ending the double taxation of dividends, and no fewer than five separate legislative proposals were before Congress to accomplish this task when President Bush presented his plan. Virtually all economists would agree (a profession hardly known for unanimity of opinion) that ending the double taxation of dividends is long overdue, providing fundamental reform by removing some of the worst distortions and biases introduced by our tax system.

Biases and Distortions

The current tax treatment of dividends introduces a number of biases and distortions. One of the principal concerns is that it can distort corporate financing decisions, which prove to be less efficient for the firm and for the economy in the long run. Corporations raise capital through three principal methods: debt, equity and retained earnings. Current law introduces a tax bias against equity financing and in favor of use of retained earnings and debt financing, both of which are taxed more lightly. Debt receives the most favorable tax treatment. Interest payments are a deductible expense for corporations and hence reduce the amount of corporate profits subject to tax, while dividends are paid out of after-tax funds. Interest payments are taxed once, at most, at the individual level, and more lightly than dividends.

Retained earnings are also taxed twice, but not as heavily as dividends. Retaining earnings for investment purposes tends to push a firm's share prices higher. That additional price appreciation raises shareholders' capital gains taxes by a commensurate amount when the shareholder decides to sell their shares. However, capital gains tax rates are lower than ordinary income tax rates and investors determine when they sell their shares, potentially deferring these taxes almost indefinitely. As a result, retained earnings generate lower taxes at the individual level than dividend payments, which are subject to tax in the year in which the payment was made at individual tax rates.

These biases distort corporate decisions. The bias in favor of debt financing encourages companies to become more highly leveraged. Greater leverage leaves companies more prone to failure when their revenues fall and/or market interest rates rise. A corporation that relies more heavily on equity financing has more flexibility to meet fluctuations in the business cycle, reducing or raising dividends to reflect changes in net income. A heavily indebted company has much less adjustment capability in the face of market forces it cannot influence. Logically, one would expect higher bankruptcy rates and greater volatility in asset prices as a result. Those expectations have been met in a sustained manner.


Non-Financial Corporate Debt and Household Debt
(as a percent of GDP)
80%
70%
60%
50%
40%
30%
20%
10%
0%
Household debt as % of GDP
Non-financial corporate debt as % of GDP
1970Q1
1971Q1
1972Q1
1973Q1
1974Q1
1975Q1
1976Q1
1977Q1
1978Q1
1979Q1
1980Q1
1981Q1
1982Q1
1983Q1
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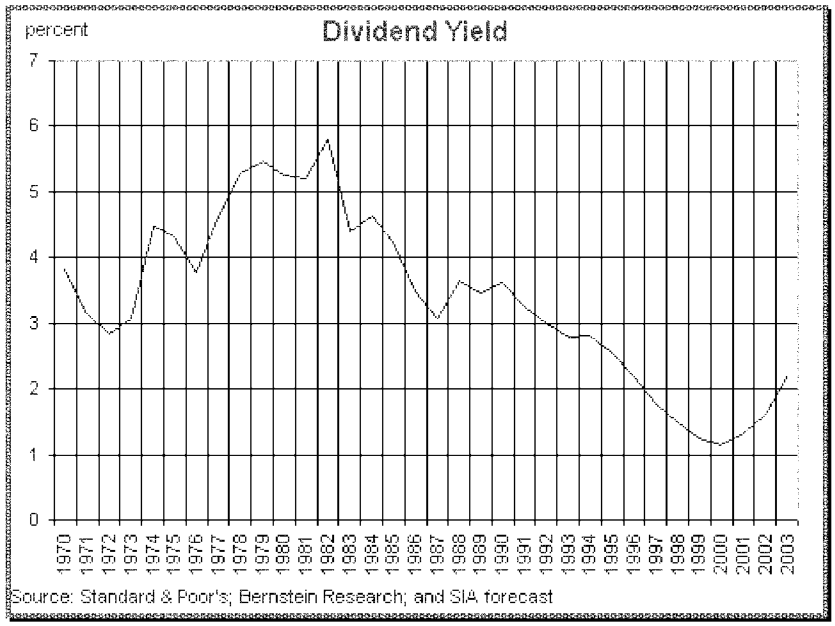


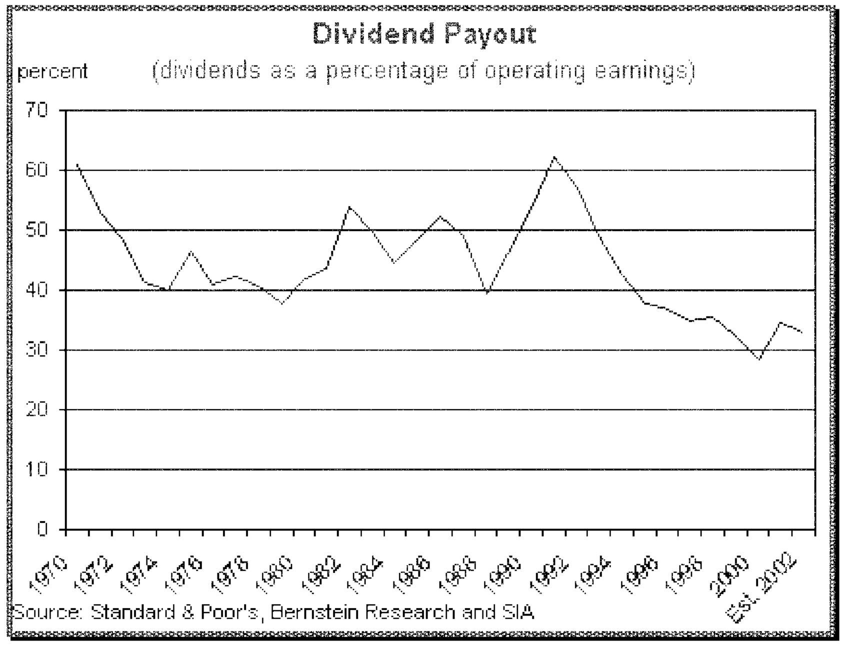
From the standpoint of the corporation trying to provide the greatest economic benefits to its shareholders, the current tax system favors retaining earnings and using them to buy back stock rather than distribute them in the form of dividends. To the investor, the buyback raises stock prices (or prevents them from falling) and thereby generates a capital gains tax liability only if the investor chooses to sell. To tax-sensitive investors, the lower tax rate on capital gains makes it a preferable way to receive income. A surge in buybacks in the past decade has been coincident with dramatic growth of option-based compensation programs, and, increasingly, retained earnings have been used to fund the repurchase of shares granted through the exercise of these options. This surge has mirrored the decline in the dividend yield. During the 1990s, this form of variable compensation accounted for a greater and greater share of total compensation.[4]

Although the evidence is far from clear regarding the impact of the second distortion, some would argue that the tax bias against equity financing and in favor of retained earnings may also distort the value of marginal investment decisions, encouraging investment in less productive projects or ones that do not add to shareholder value or add relatively little. Limiting the amount of funds over which managers have discretion may be one way to impose discipline in corporate investment decisions. Shareholders looking for the best return have far more options than corporate management and will, on average, prove more efficient in reinvesting surpluses. The more efficient "resource allocation" would likely lead to greater productivity and wealth in the economy.

These tax biases have discouraged the use of equity as a financing mechanism (except as a method to fund compensation) and discouraged the use of dividends as a method of providing benefits to shareholders. Companies which pay dividends have declined both as a share of the total number of listed firms and as a share of the total market capitalization. As dividends became less and less important in investors' expectations of the total return on investments, an equity holder looks chiefly, if not solely, to price appreciation. This may have encouraged corporate management to focus more than in the past on these and other activities that sus-

[4] "In 1999, over 34% of publicly traded companies engaged in share repurchases, up from 28% in 1992. More striking is the fact that by 1999, almost 20% of earnings were paid out by share repurchases, nearly triple that of 1992." Statement by Pam Olson, Assistant Secretary for Tax Policy, Department of the Treasury, January 23, 2003. Both percentages continued to rise before peaking in 2001.

tain stock price appreciation and relatively less on ensuring the continuous, profitable operation of the firm required to sustain a long-term dividend stream.



Investors too may have fallen prey to focusing disproportionately on short-term, often transitory, price appreciation, in part due to this tax bias. Removing the tax bias against dividends might encourage individual investors to pursue sounder, more fundamental investment strategies to their long run financial benefit. According to a study by T. Rowe Price, dividends accounted for 50.8 percent of the total return of the Standard & Poor's 500 Index from 1980–2002. Dividends can offset a lack of price appreciation (or outright price declines) and always enhance total return.

Dividend paying companies tend to outperform those that do not pay dividends. In a study by Fama and French,[5] which evaluated companies over the period 1963 to 1998, companies that paid dividends offered a higher return on assets (7.8 percent versus 5.4 percent) and a higher return on equity (12.8 percent versus 6.2 percent) than did companies that did not pay a dividend.[6] In a study by Standard & Poor's covering the three bear market years, 2000–2002, dividend payers in the Standard & Poor's 500 Index roughly broke even, while non-dividend paying firms fell significantly.[7] The prices of dividend paying stocks also tend to be less volatile, further enhancing their relative returns on a risk-adjusted basis. Discouraging dividends does little, if anything, to enhance investor returns and may well drive them lower than they would be otherwise.

The current tax biases may also distort the choice of the organizational form of firms. The higher tax on corporations (C-corporations) relative to other businesses (such as S-corporations, partnerships, sole proprietorships and non-profit organizations) may distort the allocation of capital and entail an inefficient use of resources

[5] E.F. Fama, and K.R. French, "Taxes, Financing Decisions and Firm Value," *Journal of Finance* 53, 1998, pp. 819–843.

[6] A recent paper by K. Fuller and M. Goldstein found that over the period 1970–2000, dividend paying stocks outperformed those that did not, by on average 1.4 percent per month versus 0.9 percent per month. L. Kirschner and R. Bernstein of Merrill Lynch found that from the NASDAQ's inception in 1971 through September 2001, the tech-laden index under performed the S&P Utilities index (11.2% p.a. versus 12.0%).

[7] Standard & Poor's *The Outlook*, "Dividends End 2002 on a Strong Note", January 2, 2003. In just 2002, dividend payers in the S&P 500 averaged a decline of 18.4%, compared with a 30.3% average plunge for stocks in the index that did not pay dividends.

and reduce productivity and income.[8] According to the U.S. Treasury, "from 1980 to 1999, net income of C corporations fell from 78% to 57% of all business income with net income of flow throughs rising by a corresponding amount. Similarly, the gross receipts of C corporations fell from 87% to 72% of all business receipts with the gross receipts of flow throughs rising by a corresponding amount."[9] The choice of organizational form may also have a direct bearing on the level of transparency and the degree of disclosure of financial information to investors.

The bias against dividends may also have contributed to the wave of recent corporate governance failures, and some portion of these multi-billion dollar failures should be assigned to the costs of this distortion. Dividend payments constrain the discretionary behavior of managers. Reducing the amount of cash at the discretion of management may reduce opportunities for corporate governance failures and lead management to undertake only the most productive investments and those that increase shareholder value. In addition, the tax biases may encourage managers to engage in transactions and activities solely for the purpose of reducing tax liabilities, incentives that would be reduced under a more neutral tax system.

Often referred to as "discipline of the dividend", payment of dividends forces managers to put less focus on short-term share price movements and more attention to sustainable profitability. A firm cannot pay dividends for any length of time unless it has a continuing stream of earnings to support such payments. Dividend payments also provide a "signaling function", providing management with a channel to inform investors about expectations of the firm's future cash flows and profitability.

The President's Proposal

On January 7, 2003, President Bush formally unveiled a $674 billion job creation and economic growth package that would, among other provisions, exclude dividends paid by corporations to individuals out of previously taxed corporate income from the individual's taxable income. The provision would be effective for dividends paid on or after January 1, 2003, with respect to corporate earnings after 2001, and accounts for the bulk, some $364 billion over the next decade, of the tax cut package.

To ensure that corporate income is taxed once but only once, an excludable dividend account (EDA)[10] would be created. This EDA would be the mechanism to determine the amount of income that has been fully taxed at the corporate level and, thus the amount of distributions to shareholders that would not be taxable. If a corporation made distributions in excess of the amount of earnings and profits that has already been fully taxed at the corporate level the excess distributions would be a taxable dividend to shareholders (or constitute a capital gain or a return of shareholders' investment). According to a Treasury release, the EDA will be computed using a relatively simple formula[11] and provided annually by corporations to shareholders.[12]

In order to avoid a bias against retained earnings, (to effectively treat dividends and retained earnings alike) the proposal would allow corporations to make an adjustment that would flow through to their shareholders. The proposal would permit corporations that reinvest their taxed earnings to elect, either through a direct dividend reinvestment plan or through a "deemed dividend distribution",[13] to increase shareholders' stock basis[14] to reflect the taxed income that the corporation was re-

[8] This observation provided impetus to past proposals, to reduce this and other economic distortions, including the Report of the U.S. Treasury Department, *Integration of the Individual and Corporate Tax Systems,* January 1992.

[9] Op.cit. 4.

[10] A similar mechanism exists under current law. Distributions are treated as dividends only to the extent the corporation have earnings and profits.

[11] Annual additions to EDA = (U.S. taxes + foreign tax credits used to offset U.S. tax liability)/ .35 minus U.S. taxes + foreign tax credits used to offset U.S. tax liability + excludable dividend income. A corporation's U.S. taxes would include the total tax amount reflected on its U.S. federal income tax return filed during the calendar year. The first calculation is due September 15, 2003, using 2002 numbers.

[12] A corporation, mutual fund or stockbroker would be required to provide shareholders with the information they need in an end-of-year tax statement sent every January. The statement would indicate: how much of the dividend is tax free; how much of the dividend, if any, is taxable; and how much shareholders can add to what they paid for the stock to determine their tax when they sell their stock. This amount is the adjustment to shareholders' basis.

[13] A company would be required to treat undistributed or retained earnings as giving rise to a "deemed paid EDA"—the amount would be treated as distributed and recontributed to the corporation, with an adjustment to increase the shareholders stock basis, without additional tax at the shareholder level.

[14] Basis in the case of equity is the original cost of purchase of the shares plus transaction costs and adjustments for splits and if this proposal is approved, for deemed dividends. Adjustments to shareholders basis are to be made annually on December 31st by the amount retained

taining. The change in basis would reduce the amount of capital gains tax liability when shareholders realize those gains through a sale of stock. The proposal would permit a mutual fund or a real estate investment trust that receives excludable dividends to pass those excludable dividends through tax-free to shareholders.

This element of the proposal, which will lower capital gains taxes, balances the views of both sides in a long-running dividend tax debate.[15] The traditional view of dividend taxation holds that lowering dividend taxes would make it easier for companies to raise capital that they could then pour into new plants and equipment. The opposing view holds that it would also make shareholders more demanding. "With lower dividend taxes, investors would expect executives to pay out more of their earnings in the form of dividends rather than pour them into new projects."[16] To incorporate both views, the "deemed dividend" was added to the President's proposal, which will allow a company to pursue investments funded by retained earnings and still pass along tax benefits to the investor through an adjustment of basis similar to those received in a dividend distribution. This will reduce shareholders' incentives to demand dividends from companies and make them more tolerant of reinvestment by companies by restoring some of the incentives to focus on capital gains. It will however limit some of the benefits already mention from elimination of the dividend tax that would prevail in the absence of this provision. The balancing of these two effects will likely be determined company by company and vary significantly across industries and sectors. Overall, the net investment impact is positive and significant, but likely will be less than most proponents expect.

Assessing Economic Effects

Any realistic evaluation of the impact of this proposal must assess how individuals and businesses respond to it, the timing of its implementation and the likely evolution of macroeconomic variables. Thus far, estimates of the costs of this proposal are incomplete, while quantification of its benefits has been more the subject of partisan debate than the object of balanced appraisal. Both appear to be overstated. Overall, it would appear that the conclusion reached by the Treasury a decade ago still holds true: the long run benefits derived from eliminating biases and distortions is roughly comparable to the costs generated by lost tax revenues and resultant higher fiscal deficits. If one includes the long-term benefits of higher growth in incomes and jobs, the balance tips well in favor of the proposal.

Official projections of the impact of this proposal, those provided by the Administration and Congress, employ static analysis, and hence do not include any increase in economic growth likely to arise due to this tax change. This amount would be substantial and appears, in the long term, to outweigh the costs of the proposal. That Treasury study[17] from a decade ago suggested that even in the absence of increased investment eliminating double taxation would eventually raise economic welfare in the United States by about 0.5 percent of consumption, equal to about $36 billion each year (in 2003 dollars). Put differently, the reduced distortion of business decisions would be equivalent to receiving additional income of $36 billion every year forever. In addition, higher investment due to the lower tax on capital income would promote higher wages in the long run. The proposal would also enhance near-term economic growth.[18]

The President's Council of Economic Advisers (CEA) expects the dividend proposal, combined with the President's other proposals, to jointly add 0.4 percent to real GDP growth in 2003 and 1.1 percent in 2004. Over the next five years, GDP growth would be 0.2 percent higher on average. They estimate that the increase in the federal deficit if no impact of faster growth were factored in would total $146 billion for fiscal years 2003 and 2004, and $359 billion cumulatively for the period, 2003 to 2007. Including the impact of faster growth reduces those amounts to $119 billion and $166 billion, respectively, over the next two and five years. Roughly half these amounts are attributable to the dividend proposal, although a separate breakout has not yet been provided. This analysis assumes the proposal has no direct impact on equity markets and that no change in the stance of monetary policy occurs over the forecast period. It also makes relatively conservative assumptions concerning the impact of faster growth on Federal budget receipts (a $1 rise in real

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per share. Corporations would report to shareholders the amount of Excludable Dividends and basis adjustments annually on IRS Form 1099.

[15] See J. Hilsenrath, "Dividend Plan Straddles Academic Debate", *The New York Times*, The Outlook, Economy, January 2003. See also K. Hassett, and A. Auerbach, "On the Marginal Source of Investment Funds", *Journal of Public Economics*, December 2002, p. 205–232.

[16] Ibid.

[17] Report of the U.S. Treasury Department, *Integration of the Individual and Corporate Tax Systems*, January 1992.

[18] Op.cit. 3, p. 1–2.

GDP generates 20 cents of Federal revenue) given the specific set of tax proposals considered.

The President's Proposals and the Economy

Impact of President's Proposals	2003	2004	2003–2007
Faster Real GDP Growth			
(Q4 to Q4, percentage points)	1.0	0.8	0.2 *
(Year avg to Year avg, percentage points)	0.4	1.1	0.2 *
Additional Employment Growth			
(Q4 to Q4)	510,000	891,000	140,000 *
(Year avg to Year avg)	192,000	900,000	170,000 *
Lower Unemployment Rate			
(Q4 level, percentage points)	−0.3	−0.8	−0.5 *
(Annual average, percentage points)	−0.1	−0.6	−0.5 *
Change in Fiscal Balance; No Impact of Faster Growth ($ billions, fiscal year)	−33	−113	−359 +
Change in Fiscal Balance; Including Impact of Faster Growth [1] ($ billions, fiscal year)	−31	−82	−166 +

* Average, 2003–2007
+ Total, 2003–2007
[1] Excludes change in debt service

Most private sector analysts expect the proposals' impact over this period to be somewhat lower,[19] and more in line with the Federal Reserve's economic model, which "suggests that the add-on to GDP growth from a tax cut of this size would be just 0.4% and 0.7% in the first two years after enactment, respectively."[20] Benefits from the dividend proposal are expected to be negligible in the near term. While the proposal might become effective as early as 3Q 2003 and be applied retroactively, it is unlikely to alter consumer or investor behavior markedly before taxpayers begin to file in 2004, and the full benefits of the dividend tax break unlikely to be seen until the end of the second year.

Saving Rates by Income Quintile

Saving rates by income quintile estimated by Federal Reserve				
age group	30 − 59 (CES)	70 − 79 (CES)	average (CES)	30 − 59 (PSID)
quintile 1	−0.23	−0.49	−0.36	0
quintile 2	0.15	−0.34	−0.09	0.02
quintile 3	0.27	−0.14	0.07	0.05
quintile 4	0.35	0.05	0.2	0.05
quintile 5	0.46	0.32	0.39	0.11
Implied weighted average saving and spending rates from Bush tax proposal				
Saving rate	0.42	0.24	0.33	0.09
Spending rate	0.58	0.76	0.67	0.91
Domestic spending rate	0.52	0.68	0.6	0.81

Note: Spending rate equals 1 minus the saving rate. The domestic spending rate is the share of total spending that is allocated to domestically produced goods and services, which we estimate at about 89% of total spending.
Source: Citizens for Tax Justice, Federal Reserve Board, and UBS Warburg LLC estimates.

[19] See for example, UBS Warburg, Global Economic Strategy Research, *U.S. Economic Perspectives*: "Time for a Tax Cut", January 10, 2003, which concluded "the lift for the economy looks likely to be smaller than the tax cut, which will total about 0.9% of GDP over the next 16 months.
[20] Ibid, p. 6.

Part of the reason for the lower estimates is that fiscal "stimulus will be stunted by leakage to savings." The boost to growth will be constrained as households save a portion of the increased after-tax income. Average savings rates have risen recently from record lows to about 4.3 percent, "but the 'leakage' from savings in the current tax cut could be larger than usual because the well-to-do will benefit disproportionately from the proposed tax cut" and they save more than low-income households. For example, the top income quintile, on average, can be expected to save as much as 39 percent out of after-tax income, while the next highest income quintile would likely save 20 percent.[21] Savings rates for the bottom two income quintiles are negative. Although savings rates rise with income among elderly households too, savings rates are lower at every income level than in younger households. Using these savings rates and the distribution of dividend receipts across income brackets provided by individual income tax return data for 2000, the latest year for which detailed data are readily available, one can estimated the share of the proposal which will be spent and what proportion will likely be saved.

These estimates indicate that the near term stimulus to growth would be small, in line with the Administration's estimates of a reduction in tax revenues between now and April 2004 of only $20 billion. Even those benefits may be overestimated and are unlikely to arrive until after investors turn their attention to tax matters at the start of 2004. Rather than provide a burst of short-term stimulus to consumption, which would likely prove transitory, it seeks to boost long-term growth by providing incentives to savings and investment. In that respect, it should succeed, in that the benefits flow to those most likely to save and invest the proceeds. Assuming half the benefits of the proposal go to the top two income quintiles, fully one-third of this amount would likely be saved, and the remainder spent.

The estimates of the costs of the proposal may also prove to be high for other reasons. The estimates are based in part on tax data on dividends for 2000, and substantial changes in income impacted by this proposal have occurred since then that suggested the estimates should be lowered. Some portion of the dividend income received by individuals reported in the tax data includes interest payments from money market mutual funds and bond funds, in addition to stock dividend income received outside of retirement plans and other tax-deferred vehicles, for which adjustments were made. However, since that time portfolios have changed. For example, during 2002, there was a net inflow into taxable bond funds of $124 billion, while the first annual net outflow of long term funds from stock mutual funds since 1988 occurred: some $27 billion. Individual investors also reduced their holdings of individual stocks. As a result, the portion of income derived from these interest payments and reported as dividends for calculation of AGI will be higher when tax returns are filed this spring and the adjustments made by those providing estimates should be commensurately raised.

In 2000, corporations paid an estimated $201 billion in dividends out of after-tax incomes.[22] More than half of these dividends were paid to tax-exempt entities—such as pension funds, IRAs, and non-profit foundations—or to individuals that owed no income tax. As a result, only about 46 percent of the dividends paid by corporations to individuals (or $93 billion in dividends) were subject to individual income tax in 2000.[23] These figures include those interest payments mentioned above. Since then, actual dividend payments fell 3.3 percent in 2001 before rising 2.1 percent last year. Equity ownership rose in 2001 in terms of the number of households and individuals holding equities, but fell as a portion of overall financial assets, as flows moved from equity to debt and as equity prices continued their three year decline.

In addition, it would appear that investors in recent years have allocated an increased portion of their equity holdings to tax deferred accounts such as 401(k) plans, IRA's and Keoghs and a corresponding portion of corporate bond holdings to their taxable portfolio,[24] and these trends appear to have continued in the past three years. As a result, the percentage of total dividends paid by corporations to individuals' taxable accounts has fallen significantly, to about 40 percent, from the 46 percent estimated for 2000. This investor behavior appears to be the opposite of what conventional wisdom would predict, but has rational explanations, and is largely induced by distortions introduced by the current tax policy. Stocks are ex-

[21] *Federal Reserve Consumer Expenditure Survey*, 2000 http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html

[22] The Urban Institute-Brookings institution Tax Policy Center.

[23] William G. Gale, "About Half of Dividend Payments Do Not Face Double Taxation", *Tax Notes*, November 11, 2002.

[24] James M. Poterba, *The Rise of the "Equity Culture:" U.S. Stockownership Patterns, 1989–1998,* Massachusetts Institute of Technology, January 2001, http://econ-www.mit.edu/faculty/poterba/files/aea2001.pdf

pected to have most of their payout in the form of capital gains, which are taxed relatively lightly, while bonds pay interest, which is more highly taxed. Investors would be expected to choose to put the riskier asset, stocks, in the taxable portfolio and bonds in the tax-deferred account. Just the opposite has occurred in practice. One study notes that "if taxes on dividends were eliminated, there would be greater incentive to hold stocks outside a tax-sheltered portfolio. So we would expect to see investor portfolios shift more in the direction the theory predicts: taxable bonds in tax-deferred accounts, and stocks in taxable accounts to the advantage of lightly taxed capital gains and untaxed dividends." [25] The impact of changes in securities ownership, both actual changes in the last two years and prospective changes if the proposal is approved, need to be added to the analysis.

[25] H. Varian, "What would be the long-run impact of tax-free dividends on the market?" *The New York Times, Economic Scene,* January 16, 2003, p. C2.

U.S. Household Ownership of Equities, 1999 and 2002

	Percent of All Households		Number of Households (millions)		Number of Indiv. Investors (millions)	
	1999	2002	1999	2002	1999	2002
Any type of equity (net)[1, 2]	48.2	49.5	49.2	52.7	78.7	84.3
Any equity inside employer-sponsored retirement plans	31.8	34.0	32.5	36.2	52.0	57.9
Any equity outside employer-sponsored retirement plans	35.5	33.7	36.3	35.9	61.6	57.4
Individual stock (net)[1]	26.1	23.9	26.7	25.4	40.0	38.1
Individual stock inside employer-sponsored retirement plans	10.5	8.3	10.7	8.8	14.0	12.3
Employer stock inside employer-sponsored retirement plans[3]	6.0	5.6	6.1	6.0	8.0	7.8
Non-employer stock inside employer-sponsored retirement plans[4]	8.0	3.5	8.2	3.7	11.4	5.2
Individual stock outside employer-sponsored retirement plans[3]	21.4	19.7	21.9	21.0	32.8	31.5
Stock mutual funds (net)[1]	40.9	44.2	41.8	47.0	66.8	70.5
Stock mutual funds inside employer-sponsored retirement plans	27.9	31.2	28.5	33.2	39.9	46.5
Stock mutual funds outside employer-sponsored retirement plans	27.2	27.0	27.8	28.7	44.4	43.1

[1] Multiple responses included.
[2] The average number of individuals owning equities per household owning equities was 1.6 in 1999 and 2002.
[3] Excludes employer stock options.

[4] The decline in the number of households and individual investors owning non-employer stock inside employer-sponsored retirement plans reflects a change in questionnaire design. In the 2002 survey, respondents owning non-employer stock inside retirement plans had to indicate that their plans provided a brokerage account window. The 1999 survey did not include a question about brokerage account windows.

Note: The U.S. had approximately 106.4 million households in 2001, the most recent estimate available [U.S. Bureau of the Census, Current Population Reports, p. 60–213 (September 2001)].

Source: *Equity Ownership in America 2002,* Investment Company Institute and the Securities Industry Association, www.sia.com/publications/pdf/equity—owners02.pdf

The most tangible economic benefits of the proposal arise from the increased incentives to savings and investment. These additional savings are invested and spur additional capital formation, boosting business fixed investment spending and generating additional output and jobs. This, combined with the likely effects of the additional consumption spending and the additional investment income, provides for substantially lower cost estimates of the proposal, and ones roughly in line with the dynamic estimates provided by the CEA. These benefits generate additional tax revenues sufficient to offset slightly more than half the tax revenues foregone by the proposal.

Other dynamic effects of the proposal, such as the impact on capital markets (including a boost, albeit small, to equity prices) and the long run encouragement of higher rates of savings and investment need to be considered. Estimates of the increase in stockholder wealth generated by the proposal, which range from $600 billion to $1.7 trillion, also appear to be overstated, but still large. These latter effects arrive with substantial lags and are difficult to forecast, but are likely to grow over the long term. This suggests that while the stimulative effects of the proposal are muted in the near term, they will likely expand significantly over time, as investor and consumer behavior changes in response to this fundamental reform.

In conclusion, the President's proposal is worthy of support. Its value rests in the very reasons for which it is most heavily criticized: that it does not provide a short-term stimulus to consumption, nor achieve any redistribution of tax burdens across income groups. Instead it provides a long-term boost to saving and investment, a boost that provides lasting support for growth in jobs and income. This is particularly important now since the recent recession, unlike most in history, was not led by a decline in consumption. Instead, consumption has been sustained, growing in excess of income with the deficit filled by record levels of debt in both the household and corporate sector. This deficit in the corporate sector which reached 6 percent of GDP at its peak in 2000 has since fallen to a more manageable 2 percent last year, while consumers have thus far failed to retrench, encouraged to continue to borrow and spend by recent fiscal and monetary policy.

Prospects for emerging from the economy's current "soft patch"[26] might well be dependent on a revival of sharply reduced and still moribund business fixed investment before consumers inevitably retrench, as they may well be doing in early 2003. The need for longer-term stimulus is even more pressing if America goes to war in the months ahead. Such action could well plunge the U.S. economy into renewed recession late this year, and fiscal stimulus delayed until early 2004 might well prove very timely.

More importantly for our long term economic health and fiscal stability is the direct support for savings provided by the proposal. This represents fundamental reform rather than countercyclical tinkering. Americans do not save enough—not nearly enough and it is not even close. We do not save enough for retirement, which is the principal goal of equity investors, cited by 89 percent of those surveyed,[27] nor enough to meet other primary objectives such as college education. The President's proposal addresses this problem directly and will change savings and investment behavior, slowly over time, but permanently for the better. Americans are too myopic and consumption-oriented to the point of their long-term detriment. If the fiscal cost of altering that (in terms of reduced tax revenues and less stimulus to current spending in the near term) is viewed as too great, it should be an invitation to more, not less, fundamental tax reform to remedy that problem, rather than rejecting a proposal which removes some of the most egregious distortions and biases of our tax system and addresses some of America's most pressing needs. From a broader macroeconomic perspective the long run benefits of the proposal outweigh these costs.

Frank A. Fernandez
Senior Vice President, Chief Economist
and Director, Research

Chairman THOMAS. Thank you, Mr. Chairman. Mr. Stack?

[26] A euphemism for the decline in real GDP growth in Q4 2002 to less than 1 percent and perhaps still lower in the current quarter, in large part due to weak corporate earnings, geopolitical uncertainties and a loss to public trust and confidence arising from corporate governance failures, and other elements of the hangover from one of the worst speculative manias in our history, all factors unlikely to be affected by a short-term stimulus to consumption.

[27] *Equity Ownership in America, 2002*, Investment Company Institute and the Securities Industry Association, www.sia.com/publications/pdf/equity—owners02.pdf.

STATEMENT OF RONALD STACK, MANAGING DIRECTOR AND HEAD OF FINANCE, LEHMAN BROTHERS, NEW YORK, NEW YORK, AND CHAIRMAN, MUNICIPAL SECURITIES DIVISION, BOND MARKET ASSOCIATION

Mr. STACK. Thank you. Thank you, Chairman Thomas, and good afternoon.

I am pleased to be here today on behalf of the Bond Market Association to discuss the President's jobs and growth package. My area of expertise is the municipal bond market. I am Chairman of the Association's Municipal Securities Division, and I have worked in the area of State and local finance for 18 years as an investment banker and eight in the Governor's office of New York State.

First, the Association fully supports the President's proposal to eliminate the double taxation of corporate earnings by exempting certain dividends from the income tax and allowing basis adjustments in cases where companies do not distribute dividends.

The proposal is bold and constructive and we believe will lead to lower capital costs for corporations, more capital investment and more jobs and economic growth. Virtually everyone agrees that there is absolutely no policy justification for the multiple taxation of corporate earnings in the current tax code.

Now, what will be the impact of a new class of tax-advantaged instruments on the tax-exempt municipal market? Intuitively, the creation of a new class of assets with a tax preference would decrease the demand for municipals and thus increase borrowing costs. In fact, many municipal bond market participants legitimately and forcefully have argued that the dividend proposal will cause disruption in the market and that tax-exempt stock dividends will attract mainstream municipal bond investors away from bonds and into stocks.

While this may indeed occur on the longer maturities, we believe this effect will not be widespread and will not result in a wholesale reallocation of assets. Why? Simply put, investors buy equities in fixed-income securities for very different reasons. Investors buy bonds primarily for capital preservation, while they buy stocks for capital appreciation, which are significantly five times more volatile;

Second, bonds offer higher rates of return than the dividend yields on most stocks;

Third, bonds offer more security and certainty of predetermined interest payments than stocks.

However, when we focus on corporate demand for municipal bonds, we find the proposal to exempt dividends from taxation does have a significant market effect. Corporations currently hold just under 25 percent of all outstanding municipals. Most of that is held by property and casualty insurers in commercial banks. Any change in tax law that would eliminate this group of buyers would significantly affect municipal bonds and increase borrowing costs for States and localities.

Under the President's proposal, corporations could distribute dividends or basis step-up only to the extent of the tax income. Municipal bond interest is exempt from income tax, it cannot be included in the EDA that determines the amount of a company's tax-free dividends.

In essence, municipal bond interest earned by a corporation would become taxable and pass through to shareholders. The result would be a significantly lower rate of return at the shareholder level for municipal bond interest than for comparable taxable interest. Consequently, many corporations, if not most, would shift out of municipals, and the loss of demand would drive up borrowing costs for State and local governments.

Fortunately, there is a simple solution to this issue, which is consistent with the President's principle. The proposal should be amended so that corporations can include municipal bond interest into calculations of EDA. Since municipal bond investors already pay an implicit tax on their investment and form a reduced pretax yield, the President's principle would remain intact.

Of course, the benefit of this tax is realized by the State or local bond issuer, not the Federal Government, in the form of lower borrowing costs. Moreover, this change would maintain the policy decision that the Congress made 90 years ago with the adoption of the very first Internal Revenue Code that municipal bond interest should be exempt from Federal taxation.

It also, interestingly, is consistent with the Treasury Department's December 1992 report on corporate tax integration, which adopted an approach very similar to the President's current approach, but which did include municipal bond interest in distributable tax-exempt dividends.

In sum, we believe the worthy goal of eliminating the multiple taxation of corporate earnings can be achieved without significant disruption to the bond market and municipals or major increases in borrowing costs. We urge the Committee to adopt our modification to the President's dividend proposal when you formally consider this legislation.

Thank you, again, for this opportunity to testify.

[The prepared statement of Mr. Stack follows:]

Statement of Ronald Stack, Managing Director and Head of Finance, Lehman Brothers, New York, New York, and Chairman, Municipal Securities Division, Bond Market Association

Thank you, Chairman Thomas, for the opportunity to testify today on the president's economic growth proposals. My name is Ronald Stack and I am a managing director and the head of Public Finance for Lehman Brothers. I am here on behalf of The Bond Market Association, which represents securities firms and banks that underwrite, distribute and trade debt securities domestically and internationally. I am Chairman of the Association's Municipal Securities Division and a member of its Board of Directors. Association member firms account for in excess of 95 percent of all primary issuance and secondary market activity in the U.S. debt capital markets, including the underwriting and trading of state and local government securities.

The Association supports the president's jobs and growth plan and has long supported eliminating the double taxation of corporate profits. There is no policy justification for taxing corporate earnings more than once. The multiple taxation of corporate earnings is distortive and excessive. The corporate tax code should not create an environment that inappropriately influences corporate financing decisions as the current circumstances of double taxation does.

The federal tax-exemption of the interest earned by investors on most municipal securities is one of the most important sources of federal assistance to states and localities. Every year, state and local governments save tens of billions of dollars in interest expense due to the tax-exemption. This savings makes it possible to finance schools, roads, airports, environmental infrastructure, low-income housing and a variety of other capital projects cheaply and efficiently. States and localities currently face significant fiscal constraints brought about by a weak economy, a

poorly performing stock market and increasing pressures on spending. Today more than ever, state and local governments need the important assistance provided by tax-exempt financing.

The president's jobs and growth package is a constructive plan that will lead to greater capital investment and a stronger economy. Some observers, however, have questioned whether the provision to exempt dividend payments from ordinary income taxes could—by making dividend-paying equities a stronger competitor of municipal bonds—lure investors away from the municipal market and drive up financing costs at the state and local level. It is too soon to be certain exactly what effect exempting dividends from the income tax will have on the municipal market, especially since we do not yet know the details of the plan that will emerge from congressional debate. However, making dividend payments on equities tax-exempt is not likely to create a substitute for fixed-income products generally, including municipal bonds, which offer a variety of features—capital preservation, priority security, lower volatility and predefined coupon payments, among others—that will continue to make them attractive.

One aspect of the dividend proposal, however, could inhibit corporate participation in the municipal bond market and consequently drive up borrowing costs for state and local governments. Fortunately, this aspect of the proposal can be addressed in a manner consistent with the spirit of the president's proposal and current tax law—by permitting corporations to include tax-exempt income in their tax-free dividend distribution.

The Effect of Exempting Dividends from Taxation

The proposed tax exemption for dividends applies only to income on which corporations pay taxes. As interest on tax-exempt bonds is not taxable, it cannot become part of a corporation's *excludable dividend amount* (EDA), or the total amount of tax-free dividends and basis step-up which the corporation's shareholders are eligible to earn. As a result, the overall after-tax return on municipal bonds held by corporations would be reduced, and many corporations would reduce or eliminate their holdings of municipal securities.

Consider the situation from the investor's point of view. Assume a corporation has some cash to invest, and its choices are a tax-exempt municipal bond yielding 5 percent and a comparable taxable bond yielding 6.85 percent.[1] If the corporation buys the taxable bond and pays the corporate-level income tax of 35 percent, the effective return to shareholders is 4.45 percent (6.85 reduced by 35 percent). Dividends and capital gains distributed to shareholders attributable to the bond interest would not be taxable at the individual level. If the corporation buys the municipal security and the average marginal tax rate for their shareholders is 30 percent, the return to shareholders would be only 3.5 percent (5 percent reduced by 30 percent). Even though the corporation would not pay an explicit tax on its municipal bond interest, dividends and capital gains earned by shareholders and attributable to the municipal interest would be taxable at the individual level. In such an environment, many corporations would forgo the lower-yielding municipal bonds in favor of taxable investments.

Corporations currently hold just under 25 percent of outstanding municipal bonds. This figure, however, understates corporations' influence in the market. Corporations, especially property and casualty insurance companies (P&Cs) which account for approximately half of all corporate holdings of municipal bonds, play an important role as "crossover" buyers of municipal securities. By entering the market when rates of return rise to threshold levels, P&Cs help ensure that state and local borrowing rates remain stable and reasonable.

The Administration's proposal would have a particularly acute effect on P&Cs, because they are already effectively taxed on their municipal bond income. Under current law, P&Cs are permitted deductions for contributions to loss reserves. Under the "proration" provision, this deduction is reduced by an amount equal to 15 percent of the amount of municipal bond interest earned. This results in an effective tax on municipal bond interest of 5.25 percent.

While the Administration appropriately formulated the EDA to ensure that all corporate income is taxed once and only once, Congress has already decided that municipal bond interest should not be taxed at all. Excluding municipal interest from the EDA would have the effect of taxing this income when it is passed through to investors. Already, municipal bond investors can be thought to pay an implicit tax on their interest earned by accepting a lower pre-tax yield on their investment. (Of course, the benefit of this "tax" is realized by the state or local bond issuer—

[1] This difference in yield reflects the average observed yield ratio between Moody's Aa-rated municipal and corporate bonds over the period 1991–2002.

not the Federal Government—in the form of a lower borrowing cost.) Since this interest has already been taxed once, it should not be taxed again when distributed to shareholders. Moreover, the tax code already contains limitations on the deduction of interest expenses for corporations that earn tax-exempt interest. These limitations constrain corporate participation in the municipal market.

Past Treasury Department Support for TBMA Position

In 1992, the Treasury Department studied the prospect of integrating the corporate and individual income taxes. In its report issued in December 1992, the Treasury Department endorsed a plan for corporate tax integration similar to the current Administration's dividend proposal. The recommendation included a proposal which would have permitted corporations to pass through municipal bond interest to shareholders on a tax-exempt basis.

Policy Recommendations

Qualified municipal bond interest has been exempt from federal income taxation since the inception of the Internal Revenue Code. Municipal interest should not lose its tax-exempt status simply because it is earned by a corporation and redistributed to shareholders. We would, therefore, urge that the Administration's proposal be amended so that municipal bond interest earned by corporations be included in the determination of EDA. If it is not, corporate demand for state and local debt could be severely weakened, and state and local borrowing costs would likely increase significantly.

With the imposition of the income tax in 1913, Congress made clear its intention that tax-exempt municipal bond interest should not be subject to tax. As noted above, including tax-exempt interest in the EDA would assure it remains untaxed, maintaining one of the most important sources of federal assistance for state and local governments. On behalf of The Bond Market Association once again, I would like to thank you for the opportunity to express our support for the president's proposal and our suggestions for modifying the details of the dividend tax exemption.

Chairman THOMAS. Thank you, Mr. Stack. The Honorable Alan Hevesi?

STATEMENT OF THE HONORABLE ALAN G. HEVESI, NEW YORK STATE COMPTROLLER, NEW YORK, NEW YORK

Mr. HEVESI. Thank you very much, Chairman Thomas, Congressman Rangel, Members of the Committee. My name is Alan Hevesi. I am New York State comptroller and have been for 8 weeks and prior to that served for 8 years as New York City comptroller.

I have a very particular interest——

[Request that Mr. Hevesi turn on his microphone.]

Thank you very much. I will not repeat all of that vital information.

Chairman THOMAS. The 8 weeks part I found interesting, though.

Mr. HEVESI. Which part?

Chairman THOMAS. You have been in office 8 weeks.

Mr. HEVESI. In this current office, yes, sir.

Chairman THOMAS. Okay. Excuse me. I do think that, in all fairness, the gentleman from New York should give you a complete and full introduction.

Mr. RANGEL. We have the pleasure of having with us a longtime State legislator, but also one that has served our great New York City as a comptroller there, and so when the opportunity came to bring this talent and expertise to the State level, he was overwhelmingly selected by the people in the great State of New York.

I thank you for your wisdom in having him share his talents with us.

Chairman THOMAS. With the witness in front of us, we have both local and State expertise. Mr. Hevesi?

Mr. HEVESI. Thank you very much. Are there any questions? Let me just suggest that we do have a particular interest in restoring the strength of the stock market and the financial services industry. It is our home-based industry. Twenty-one percent of the wages earned in New York City come from this industry and about 15 percent of the State of New York and the health of that industry is crucial to us.

The discussion for the last almost 3 hours has been fascinating for myself, and I hope for everybody else, partly because of its dynamic, and the dynamic included assertions by those of us who are testifying about the benefits or lack of benefit of this tax proposal within a very narrow frame of reference. So the argument is very strong that double taxation is inappropriate.

I am going to give you a narrow frame of reference, too, because that is the prepared text I have, only in part, and then I want to make some larger observations because I think this debate should not spin on the narrower issues, as potent as they may be, but on the larger questions of what the Federal Government is intending to do and what the consequences are.

So, from the narrow point of view, let me just refer to my prepared text, that President Bush's tax-cut proposals will hurt New York State, will hurt New York City, other local Governments and other States. The reason is that New York State, New York City, the City of Yonkers and 41 States out of the 50 have, in their own tax codes, a coupling provision, which means if nothing changes, and the change would be very difficult, the passage of this legislation would result in immediate increases in the deficits of those States.

State tax revenues in New York, resulting from the dividend proposal and from the municipal bond effect that Ron Stack just outlined for you, if not changed, will cost the State of New York $526 million in revenues in the year 2003, $2.3 billion over the next 4 years and $9 billion over the next 10 years.

New York City, independently, will lose or will increase its deficits or lose revenues in the amount of $155 million this first year, $781 million in the next 4 years, and $3.3 billion in 10 years.

When you add Yonkers, the combined revenue loss is $700 million the first year, $3 billion over 4 years, and more than $12 billion over 10 years. If no changes are made in the decoupling, that is absolute. That will be the impact. Forty-one States will suffer revenue losses through this legislation of $4.5 billion in this first year alone.

I won't go into detail as to how we did our calculations. They were based on the reality that this proposal now assumes that 56 percent of dividends are not taxed and 44 percent are paid by companies that do not pay corporate taxes, so there are all kinds of technical issues here. The context is, adding to the deficits of these 41 States, at a time when most of them are suffering grievously because of the economy, I think is something that has to be part of the risk in the calculation that you make.

New York State, for example, has a deficit for the current fiscal year of $2.2 billion. The fiscal year ends in not quite three weeks and has another $9.3-billion deficit for the fiscal year beginning on April the 1st. Although those numbers are going up substantially, they do not take into consideration, for example, a seven times multiplier in pension costs for the State and localities. That has not yet been configured into the budgets.

Every—not every—but almost every locality is raising taxes now, and so the additional hit from these losses is going to be quite substantial. The prepared text details that. It also talks about other proposals made by the President that have a neutral effect, the increase in the child tax credit, the expansion of the 10-percent income tax. They don't have an effect, but the dividend program and the effect on the municipal bond market will directly, and immediately, if there are no changes, dramatically impact on the budgets of States and their ability to provide services.

The larger picture, however—and that is my frame of reference. The larger picture is that there are some very important consequences that have to be taken into consideration and some of which have been discussed today and some minimized.

First of all, the scenarios that have been portrayed by the supporters of the elimination of a tax on dividends, which we have just heard, involve very positive benefits, that there will be a dramatic increase and interest in the markets. Those calculations, however, have to take into consideration a variety of other variables.

The loss of confidence in the markets is not just a function of the fact that dividends are taxed. By the way, the dividends were taxed during the boom that some in this room called the "Clinton boom" for six years, in which the stock market exploded, and there were huge amounts of money invested and huge amounts of money earned and then huge amounts of money lost, and the tax wasn't a major variable.

There are other factors: the tech stock collapse, the loss of confidence as a result of corporate corruption, Enron, Cendant, WorldCom, Adelphia, Global Crossing, Tyco have affected the attitude of a lot of individual investors and even institutional investors, and I think that has to be part of the calculation as to what the positive impact will be if you eliminate the tax on dividends. Local taxes, I have mentioned.

The one other piece that I want to, and maybe this is just therapeutic for me, but for almost two hours I have been hearing how deficits don't matter, that the debt doesn't matter, that a dollar of tax savings is the same as a dollar of borrowing. It is not. When you borrow a dollar and pay it off in 20-year bonds, it costs you $3 to pay that off over time. There are interest impacts.

The huge deficits that are in prospect now are potentially very devastating to the economy. How do we know that? We did this already. In 1980, the national debt was $900 billion. In 1992, the national debt was $4.3 trillion; $3.4 trillion was borrowed in 12 years, bipartisan, by the Congress, by the President. That was an average of $280 billion in debt each year, deficits each year.

The New York Times this morning had a front-page story that said when you start talking about the tax cuts and the war, you are going to be approaching $400 billion for this year, and maybe

it is true that if that was for a year or two or three in a crisis, you certainly do get yourself out of a financial crisis, but I think everybody has a sense that this is going to go on for a long time.

It was remarkable for me, when I was a youngster in politics, watching the debates in the Congress, when Democrats were in the majority, how conservative Republicans would rail at the deficit, that this was bad for the long term and that balanced budgets should be the goal, as close as we could get to them, and it is remarkable that there are some changes in this.

I think the deficits will result in huge barriers to economic growth. You will be sucking enormous amounts of money out of the capital markets that will not be available for private business to borrow, and to invest, and to do research and development because the Federal Government will be, by law, borrowing that money and that the interest rates will be dramatically high and that the message to business that the Government does not care about these deficits and didn't care when there were surpluses. Is that clicking my notice to stop? Thank you very much. I didn't know that, as I haven't done this before.

Thank you very much, Mr. Chairman.

Chairman THOMAS. The Chair generously, out of his warm feeling for the gentleman from New York, allowed you, because you were on a roll, I didn't want to stop the roll. I was looking for a break in the roll, and we found one.

Mr. HEVESI. I am very grateful. I thought the clicking was applause, but I misinterpreted it.

[The prepared statement of Mr. Hevesi follows:]

Statement of the Honorable Alan Hevesi, New York State Comptroller, New York, New York

I would like to thank Chairman Thomas, Ranking Member Rangel and the other members of the Ways and Means Committee for allowing me to testify to you today on the impact of the President's tax proposals.

President Bush's tax cut proposals will hurt New York State, New York City, and other local government budgets. According to an analysis done by my Office, the proposal will:

- Reduce State tax revenues and increase State borrowing costs by $526 million in 2003, $2.3 billion over the next four years and $9 billion over the next 10 years.
- Reduce New York City tax revenues and increase City borrowing costs by $155 million in 2003, $781 million over the next four years and $3.3 billion over the next 10 years.
- In addition, the City of Yonkers will lose $230,000 in 2003, $1 million over the next four years and $2.9 million over the next 10 years.
- The combined impact is a revenue loss of almost $700 million in the first year, more than $3 billion over four years, and more than $12 billion over 10 years.

This comes at a time when New York State and its local governments already face huge budget gaps. New York State is currently trying to close an estimated gap of at least $2.4 billion for the year ending March 31 and another $9.3 billion for the following fiscal year. My Office estimates that New York City could face a gap of more than $3.6 billion for the fiscal year starting July 1, 2003.

This proposal not only adds to the current crisis, it also saddles us with a problem that grows rapidly year after year. Over the next 10 years, the cost would be more than $12 billion. This is a conservative estimate. Using the President's estimate that the dividend tax cut will generate $364 billion nationally, the New York cost will be almost $16 billion over 10 years.

New York is not alone in being injured by the President's proposal. Forty-one of the 50 states will lose an estimated $4.5 billion in tax revenues in the first year alone, according to the Center for Budget and Policy Priorities. This comes at a time

when States are facing budget gaps totaling between $60 billion and $85 billion for next year.

We had hoped that the Federal Government would come to the aid of the states, and especially New York, which has been hurt by the combined impact of a national economic recession and the 9/11 terrorist attacks. Instead, the President's plan would add to the already serious state and local fiscal crisis.

It is imperative that no state or city is injured by the President's proposal. If tax cuts are agreed to at the federal level, they should not automatically damage State finances. Even if States enact legislation to de-couple from the federal changes, it is unclear whether sufficient reporting of dividend income will exist in order to enable States to effectively continue to tax it.

The main components of the President's tax proposal and the effect on New York State and New York City budgets follows:

New York State and New York City would lose revenues from the proposed dividend tax exemption.

The plan calls for eliminating dividend income paid by corporations from the federal personal income tax, when dividends are paid out of previously taxed corporate income. This does not mean *all* dividends would be exempt from tax. Dividends paid from Money Market Funds and Mutual Funds would be exempt to the extent that they arise from previously taxed corporate income.

The State and New York City base their income taxes on the federal definition of income, so any reduction in federal income leads to a reduction in state and local income tax revenues. This year, New York State will collect about $925 million in taxes on dividend income from its residents.

The President's original plan was projected to eliminate taxes on about 56 percent of dividends. The tax exemption would not have applied to the 44 percent of dividends paid by companies that do not pay corporate taxes and by mutual funds. The proposal has recently been modified to extend the tax exemption to some corporations even if they do not pay taxes. Thus the following analysis may actually understate the full impact of the proposal.

But assuming 56 percent of dividends are not taxed, that will result in a State tax revenue reduction of about $520 million in the first year. New York City will lose about $125 million and Yonkers about $230,000. As dividend payouts increase over time, so would the amount of lost revenue. State revenues lost from not taxing dividends will grow to a total of $2.15 billion through 2006 and at least $6.4 billion over 10 years. New York City revenues lost will total $525 million over four years and $1.55 billion over 10 years.

New York State and New York City would lose revenues from the proposed reduction in capital gains taxation.

The President's proposal allows companies that pay taxes but do not pay dividends to give stockholders a credit that would reduce the stockholders' capital gains, thus reducing the taxes they pay on those gains. For example, say a share is bought for $100 and the company has $6.50 a share in fully taxed profits. The company will notify the shareholder of this. Then suppose the share is sold for $110—a $10 profit. The capital gains tax will apply only to $3.50 of the gains, excluding the value of the company's taxed profits from the original purchase.

This will not have a significant impact in the first year because stockholders must hold a stock for a while for capital gains to accumulate. However, over time it will substantially reduce tax revenues from capital gains for New York State and New York City.

In 1999, the most recent year for which actual data is available, State residents reported $48.3 billion in capital gains on which the State collected an estimated $3.3 billion in taxes. Revenues lost from the reduced capital gains will cost the State $200 million over four years and $1.8 billion over 10 years. New York City would lose capital gains tax revenues of $50 million over four years and $450 million over 10 years.

Proposed Tax Free Dividends and new Savings Accounts will drive higher borrowing costs for States and localities.

The President's plan will substantially increase the supply of tax-exempt investments without any increase in demand. In fact, to the extent that taxes are lower, demand for tax-exempt investments may decline. The State and its related debt issuers will therefore have to increase interest on notes and bonds to compete to attract investors.

If the interest rate the State and City pay increased by only 50 basis points, or one half of one percentage point, that will cost the State $31 million this year, $201 million over four years and $839 million over 10 years. New York City's borrowing

costs will increase by $35 million this year, $266 million over four years and $1.3 billion over 10 years.

On top of this, the new savings accounts would further expand the supply of tax-exempt options and compete with other tax-free investment vehicles such as State and local government bonds, likely necessitating additional interest rate increases. Government relies on tax-exempt bonds to support roads and bridges, school building and other important capital projects.

New tax-free savings accounts cause revenue gains in the short-term and revenue losses in the longer-term from new savings accounts.

The President's plan would create a new kind of savings plan whereby individuals pay taxes on their account contributions, but the earnings on those contributions would be tax-free when withdrawn. Currently, contributions and earnings for most IRAs, 401Ks and other long-term savings plans are generally tax deferred until they are withdrawn, at which time both contributions and earnings are taxable. The new proposal essentially provides for earnings that are never taxed.

This proposal would likely increase state and local income tax revenue in the short-term as individual investors convert or avoid traditional retirement and long-term savings plans such as IRAs, 401Ks and college savings programs to newly established savings and retirement accounts where they would pay taxes on their contributions when they are made rather than when the contributions are withdrawn many years later.

Preliminary OSC staff estimates indicate that the State and New York City could realize approximately $30 million in the first year, $360 million over the next four years, and $42 million over the course of 10 years. These figures represent the net impact of revenue increases in the first few years and reductions in receipts in the later years.

However, the longer-term impact of this proposal is a significant loss in income tax receipts. For example, the revenue loss grows over time, by the tenth year, annual losses would reach an estimated $100 million. Unlike the current savings accounts that tax earnings when withdrawals are made, these new savings accounts would exempt earnings from taxation altogether. Over the longer run this provision would have more dramatic effect on revenues as investment earnings increase, are withdrawn, and the cumulative effect of a total tax exemption is felt.

Early implementation of many of the income tax provisions passed in 2001 would reduce federal taxes without negatively affecting New York State or New York City revenues.

Implementation of rate reductions in the federal personal income tax, a reduction in the marriage penalty, an increase from $600 to $1,000 in the child tax credit, and an expansion of the 10 percent income tax bracket would be accelerated by one year. In addition, small businesses would be able to expense up to $75,000 in equipment purchases (up from the current level of $25,000), which would be indexed for inflation.

Most of these changes do not flow through to the State or local income tax bases. While the small business equipment provision would pass through to New York State, its effect on revenues would be minimal. The federal income tax changes are estimated to reduce New York taxpayers federal tax bill by an estimated $8.9 billion next year, including $2.2 billion in tax cuts related to dividend tax changes.

Note: The analysis does not account for any possible increased economic activity that may be stimulated by the tax cuts—the focus is solely on the certain direct budgetary impact on the State and local budgets.

Impact of the President's Tax Proposals on NYS and NYC Budgets

	1 Year	4 Years	10 Years
NYS			
Dividends	$(520)	$(2,150)	$(6,400)
Capital Gains	$ –	$(200)	$(1,800)
Debt Service	$(31)	$(201)	$(839)
Savings plans *	$25	$300	$35

	1 Year	4 Years	10 Years
NYS Total	$(526)	$(2,251)	$(9,004)
NYC			
Dividends	$(125)	$(525)	$(1,550)
Capital Gains	$ –	$(50)	$(450)
Debt Service	$(35)	$(266)	$(1,293)
Savings plans *	$5	$60	$7
NYC Total	$(155)	$(781)	$(3,286)
NYS and NYC	$(681)	$(3,032)	$(12,290)

* The 10-year total for the savings plan represents 2004–2013; whereas the 10-year total for the other components represent 2003–2012. The differing presentation is necessary due to the manner that the Federal Government reported its estimates.

Chairman THOMAS. Well, the Chair would just observe that the so-called Clinton boom, 6 of the 8 years the constitutionally empowered legislative body to generate revenue bills. It was under the control of the Republican Party, and I think you can deal with deficits both sides, taxing and spending, and I think significant impact was the spending restraint, so I think it was a shared benefit.

Mr. Stack, you have a quote, unquote, "solution" to remove you from the cross-hairs of the dividend proposal. Do you have a dollar amount or a cost figure associated with that change?

Mr. STACK. That is not our expertise. We have not cost it out, but our experts would be glad to get back to you with an estimate if that is what you——

Chairman THOMAS. That would be helpful, but our own estimates will do the same as well. Governor Keating, I did not hear or see in your testimony a specific solution to your concern, but I understand the relative devaluing of the annuities. Do you have a specific solution or a structured solution to your problem?

Mr. KEATING. Yes, we do, Mr. Chairman, and that would be, as I indicated, to treat a mutual fund outside of an annuity and a mutual fund inside an annuity exactly the same. If the mutual fund outside is tax free, then the mutual fund inside a variable would be subject to a step up in basis. We anticipate it would be something in the neighborhood of $3 billion over 7 years. Of course these are murky figures any time you are dealing with projections of revenue loss.

Chairman THOMAS. Mr. Schaefer, you used phrases such as "alleviate the double taxation" or "protection against the double taxation" in terms of what has occurred in other countries. The President's proposal is to tax dividends only once, to create a single or one level in integrated tax. Do you know of any country that has created a single level tax on dividends? I know you indicated that it has been alleviated and there has been protection against them, but is there any country that has actually done what the President is proposing?

Mr. SCHAEFER. My able support allows me to say that Greece as a country does, but we can get back to you for the record with the various solutions. People have come up with a number of different alternatives.

Chairman THOMAS. There is no question that there are alternatives to alleviate or reduce the problem of double taxation. The question is: have they removed entirely the double taxation to go to a single level?

Mr. SCHAEFER. Yes, one country has.

Chairman THOMAS. One country. Of course, currently, it is absolutely correct, in comparison to most other countries, I think Japan is the only one on a corporate tax structure that creates the burden that we have placed on ours, and I do not know too many people who want to emulate the Japanese structure at the current time. The question of moving to—and there may be some question about Greece, and I will have our staff check that as well.

Gentleman from New York wish to inquire?

Mr. RANGEL. Comptroller Hevesi, when you were the city comptroller you had to make certain that the city had a balanced budget; is that correct?

Mr. HEVESI. Yes, sir.

Mr. RANGEL. Of course as the State Comptroller, the States have to balance their budget. While you cited New York, the same problems that Mr. Stack has shared with us as relates to municipal bonds, governors throughout the country will have the same mandate to balance the budget. In addition to this, if you look at the President's overall legislative package, does your office review the unfunded mandates that our city and State would have as relates to lack of child care for the welfare bill, the matching funds from Medicaid and——

Mr. HEVESI. We have the capacity to do that. We have focused immediately in my short term as State Comptroller on the impact of the State budget on the local revenues, the city of New York and the unfunded mandates on the localities, but the next stop, as your budget process evolves, we will be doing those calculations as well. There are certainly a number of unfunded mandates from the Federal Government that impact on the States' budgets.

Mr. RANGEL. Have you been able to take a look at, with all of the concern that the President and the Congress have shown as a result of being hit at the World Trade Center, whether or not the funding that is coming into our city and State is coming from mandates that have already been passed, rather than having new money to resolve some of these problems?

Mr. HEVESI. Well, my understanding is that of the $21 billion that was promised for relief, about a third of it has been forthcoming. I don't know that all or most of it is coming from existing programs. My impression was that that was new money of Federal Emergency Management Agency money that had been set aside for particular recovery programs. It is slow in coming, and the cash impact, by the way, of 9–11, which is a variable we didn't mention and we should have mentioned, it has affected the entire national economy, just lost infrastructure, lost revenue, lost business income was $105 billion. So, it has had an enormous effect for us locally, of course, and had a spill over effect on our economy, on travel, on

airlines, on entertainment, on tourism, and so any way we can accelerate the Federal assistance that has been pledged is enormously important for us.

Mr. RANGEL. Well, what is the—have you shared this? I mean do you meet with other comptrollers, other governors involved with this? Have they had the same opportunity to analyze the impact of removing taxes——

Mr. HEVESI. There are associations of comptrollers. There are governors' conferences. As I say, in 8 weeks we are now dealing with—our fiscal year is April the 1st, so we are focused on that. I have a little tiff, as you know, with the MTA. We are dealing with a tremendous local issue where the presumptions by local governments of their pension contributions are about one-seventh of what the reality will be, and they are now faced with 7 times multiples in their pension contributions, and they all have to deal with that.

So we have not yet focused on the impact of the Federal budget or the proposed Federal budget on us, but we will be in communication and lobbying for whatever adjustments we hope will be forthcoming, you know, as a team, and that is comptroller's association and the Conference of State Legislators as well as the Governors Conference.

Mr. RANGEL. Governor Keating, what he is talking about, does that make any sense to you as a former governor, about the ability to get the State bonds out, the taxes and bonds out?

Mr. KEATING. Well, Congressman, I left office 6 weeks ago, so I am almost the neophyte the comptroller is. Obviously, as a result of the factors that he stated in his opening statement, State government budgets in the main are in stress. Any tax changes here have an impact on what the States can spend and how much they can collect. For example, any State that seeks to reduce its State income tax or eliminate it, will, as a consequence, increase the Federal tax burden of its citizens, if you are linked State to State. By the same token, what is proposed here will have an impact on State revenues, but in my case, and I think in the case of a lot of States in a similar position, we need more taxpayers. We need more taxpayers earning more money, and we need more taxpayers paying more taxes.

Mr. RANGEL. That is long term, but——

Mr. KEATING. The whole process here is long term.

Mr. RANGEL. Would your income tax piggyback on the Federal system like we do in New York?

Mr. KEATING. Yes.

Mr. RANGEL. So, if there is a dramatic reduction in taxes, then the States, unless they increase taxes, would suffer a loss of revenue, wouldn't they?

Mr. KEATING. Well, I don't know if this is the case in New York, but one of the problems we had, and one of the big problems in California is no capital gains taxes. Because of the collapse in the stock market, because of much of the challenged equity markets, there has been a crash in capital gains revenue. So if you remove the double taxation of dividends, if you encourage equity ownership, equity purchases, as a result of that—and this is certainly the opinion of a number of people—you will see dramatic up-

swings in the value of equities, and hopefully more capital gains revenues going to States.

Mr. RANGEL. How can the governors fold this into balancing their budget? Is this dynamic scoring?

Mr. KEATING. I am saying that in our case, in my State's case, a significant part of the loss of tax revenue year to year is the absence of any capital gains being paid or the very dramatic reduction in capital gains paid, which will have an impact.

Mr. RANGEL. This tax package would not provide the revenue to balance the budget. How would you handle that, Comptroller? Would you be able to talk about the long-term gains that we have to have in the future to balance the current budget?

Mr. HEVESI. You mean the economic activity that would be driven by this——

Mr. RANGEL. How do you fold that into a balanced budget?

Mr. HEVESI. Long term there is a potential, but to suggest that that is an absolute based solely on the formulation that there is a reduced tax and therefore people will be more active in the markets is not sufficient. You have to take into consideration a variety of other motivations for people being involved in the markets. There are many people, including institutional investors and big ticket institutions, wealthy people, who are in the markets regardless of the tax on dividends. There are other people who got into the markets who were casual before, not even involved, who got in during boom times, and the boom times are a function of a variety of larger economic factors and variables. So there are a lot of people who dropped out, as I mentioned, because they are just sour for the time being because of the corporate governance issues.

So could there be a beneficial effect long term and increase their activity? Yes. Will that match the absolute and immediate losses? There is no way to calculate that. We know the numbers of the losses for our State. I think every State could make that calculation. They are sort of absolutes. Over what period of time is that compensated for? I can't tell.

Mr. RANGEL. Thank you.

Chairman THOMAS. Thank you. I tell Mr. Schaefer, my sources tell me that Greece does not adjust for retained earnings, so that it would not be a single-level retained integrated tax. It comes close, but I do not think there is a country that has that.

The gentleman from Louisiana, the Chairman of the Select Revenue Subcommittee wish to inquire?

Mr. MCCRERY. Yes. Thank you, Mr. Chairman.

Mr. Hevesi, welcome, and believe me, you have my sympathy, as do the governors and elected officials in most of our States which are having problems, fiscal problems because of the recession, so I know you have a tough job. I also know that some of the long-term hope of the President's proposals does you no good in terms of balancing your budget, perhaps under a constitutional mandate, this year, or even next year.

To say that your revenues will be reduced because they are tied to the Federal income tax regime, really I think under values the State Government. I mean that is a State Government decision, is it not, to tie your income tax returns to the Federal returns?

Mr. HEVESI. Yes, it is a decision, but it is also based, not only the simplicity of that kind of policy, but also the difficulty if the tax is eliminated on the Federal tax form for getting the information that would drive the State taxes.

Mr. MCCRERY. I understand the reasons for it, but it is a State decision, and not all States do that.

Mr. HEVESI. That is true, yes, sir.

Mr. MCCRERY. So I mean if you just did not like Federal tax policy any more, and you wanted to vary from your current practice, you could do that with an act of the legislature, couldn't you?

Mr. HEVESI. That is correct.

Mr. MCCRERY. It is curious to me, setting aside your immediate problem which many, many States have, and you are going to have whether this proposal passes or not, setting aside your immediate problem of balancing your budget, it is curious to me that New York, of all places, would send an elected representative here to oppose the dividend proposal, when the businesses that make up such an important and vibrant part of New York City, the economy in New York City and certainly New York State are all coming to us saying, "Please, pass the dividend proposal. It would be good for us and we would create jobs, more jobs in New York City and other places." Doesn't that strike you as being at least curious?

Mr. HEVESI. No, not at all, obviously, because I am here, and taking this point of view, because again I am trying to tie this particular specific policy, which is one of many that are being proposed, to the larger picture. If the presumptions that I operate under about the larger picture are true, we are not going to be creating jobs in New York. We are going to be following the pattern of the 1980s. What was that pattern? Huge borrowing that was a function of dramatic tax cuts under President Reagan that produced dramatic cash flow in the early part of the 1980s, but not a commensurate reduction in Federal spending, in fact, dramatic increases in Federal spending, including analogously, military spending, ending up in 1986 and 1987 with an awful recession that cost our State 600,000 jobs.

Mr. MCCRERY. So are you disagreeing with the businesses that make up the stock market in New York City? Are you saying they don't know what is good for them or is there something else?

Mr. HEVESI. No, no, no. That would be unfair and that would suggest that we have a hostile relationship.

Mr. MCCRERY. No, no. I am just trying to get it straight.

Mr. HEVESI. No. In the narrow frame of reference, if you have got a particular business and you believe in focusing on your business, that this could potentially enhance your business, and philosophically you believe that double taxation is wrong, I understand the recommendation. If however, implementing that policy and the rest of the tax reduction program does not have the positive results that have been ascribed to it, but in the long term create a debt problem that is analogous to the 1980s debt problem, and ends up with us eating up so much of our resources in paying off prior debt—I mean one of the prior speakers says, "Well, you spend that money on good things." No. You are spending money to pay off debt for stuff that has been spent in the past at dramatic interest rates. If that triggers the kind of recession we had in 1987 through 1992–

93, it crippled us in New York. It crippled other locations. If that scenario is what happens, then maybe this is not the time to do the dividend tax cut. That is the point I am making.

So we are disagreeing. I mean all of this is about predicting scenarios, what is going to happen if you take a particular action? I have always been fearful of the impact that huge government debt has on the economy and how it slows down the economy.

Mr. MCCRERY. Let me just point out quickly that the deficits projected, even with the President's tax cut, amount to 3 percent of GDP, that the deficits we were running in the 1980s that you keep referring to, were 6 percent and above of GDP, huge difference.

Mr. HEVESI. Well, I don't know what those predictions are because the point has been made consistently that the deficits have not yet calculated in the cost of the war in Iraq, what happens after the war, the rehabilitation program, and those expenditures, plus the prescription drug program that is part of the President's, all of that has not yet been calculated in.

If, for example, the New York Times is correct, that we are approaching $400 billion annually compared to $280 billion back in the 1980s, we will be in the multiple trillion dollar added debt, then the fact that you approach it as a percentage of GDP, and Mr. Tanner approached it as $2,500 per taxpayer, and rising, so there are different ways to characterize this using those numbers.

Chairman THOMAS. The gentleman's time has expired. The gentleman from New York, Mr. McNulty, wish to inquire?

Mr. MCNULTY. Thank you, Mr. Chairman. I too would like to question Comptroller Hevesi. Mr. Chairman, as Charlie Rangel pointed out, Alan has a long and distinguished career in public service in New York. We served together in the State Legislature, and as a matter of fact he was a member of the State Legislature for over 20 years before becoming Comptroller of the City of New York, and of course now he is the State Comptroller.

Alan, I just wanted to build upon what you were talking about with regard to the larger issues because I do think we need to look at the big picture, and you correctly pointed out that eliminating deficits, getting to balanced budgets, reducing the national debt were primarily seen as Republican issues for many years. As a matter of fact, when I first came down here, and I have consistently talked about those issues for 15 years, I got in trouble with my own party back home because I talked about those issues so much, and if anything, my concern about those issues is deepened even further today because of the situation that we are in, and also because of the fact that in addition to having the four children I had when I came to Washington, I have five grandchildren now, and I think we are dangerously close to a policy where we are going to drown our children and grandchildren in red ink.

So, 2 years ago when the President came out with this proposal for a $1.35 trillion tax cut based upon the fact that we would have surpluses as far as the eye could see, and a $5.6 trillion surplus over 10 years, I got very nervous, and of course, today, the President acknowledges that surplus is not going to be there and we are facing deficits as far as the eye can see.

I do not want to go back in history and talk about the past. A great Governor of New York used to say, "Let's look at the record." So let's look at where we are today. We are back into deficit situations. We had $159 billion budget deficit last year. The President himself is projecting a deficit of over $300 billion this year, $300 billion the following year, deficits as far as the eye can see. We have a $6.2 trillion national debt on which we paid $332 billion in interest alone last year on that debt.

My question to you, Alan, is given the facts, given where we are right now, what is your opinion of a proposal to take $695 billion more out of the revenue stream in the form of new tax cuts?

Mr. HEVESI. Well, I think I am clear that that makes me extremely nervous. Just Mr. McCrery making reference to I come out of New York and how can I take this position in relation to our own home business? One of my jobs, you should know, is I am the sole trustee of the second largest pension fund in America, the $100 billion New York State Common Retirement System. So we have a particular interest in the growth of this market.

My fear is that this dividend tax cut, as part of a package of tax cuts at this time, is not going to have the stimulant effect of the growth effect that people predict, that in fact, based on our recent history, while there will be a short-term maybe positive effect because of the cash flow, when we pay back this huge debt, it will suck the lifeblood out of the revenues of the Government. I don't want to overstate this, but every dollar that is spent on debt service, interest on the debt, is money that is not spent for international affairs, the war, or for aid to education, or for helping out localities or for tax cuts. That money has to be paid. As it grows, somebody is going to be coming back here and saying, "We are going to have to find revenues and raise taxes again because the numbers are so enormous."

Mr. MCNULTY. I thank the Comptroller, and I thank the Chairman, and I yield back the balance of my time.

Chairman THOMAS. Thank the gentleman. Gentleman from Kentucky, Mr. Lewis, wish to inquire?

Mr. LEWIS OF KENTUCKY. Yes, thank you, Mr. Chairman. Mr. Schaefer, how many senior citizens will be helped by this elimination of the double taxation on dividends?

Mr. SCHAEFER. By our estimates, about 9.8 million people age 65 years or older own dividend paying stocks and will receive a dividend break.

Mr. LEWIS OF KENTUCKY. Mr. Hevesi, you said a little while ago that there was going to be a loss to New York State, New York City, if the elimination of the double taxation on dividends occurs. You know, it always kind of amuses me here in DC and in State government, local government, government folks always talk about a loss for their government, a loss to the government. What about the loss of money to those 9 million senior citizens that are losing money? You know, it is where the money comes from that counts, and the money comes from the taxpayer. You talk about these deficits, well——

Mr. HEVESI. Can I respond to that, just that point?

Mr. LEWIS OF KENTUCKY. Let me just finish here. In the 1980s when Ronald Reagan cut taxes, we came out of some very

tough years. I remember the Carter years, double digit inflation, double digit interest rates, bad, bad economy. When Ronald Reagan cut taxes, the revenues to the Federal Treasury doubled. They increased. What happened was the spending here in Congress, the spending. I want to ask you, how much of a surplus did New York State have in recent years? Did they have a surplus?

Mr. HEVESI. New York State has not had a surplus.

Mr. LEWIS OF KENTUCKY. Has not had a surplus?

Mr. HEVESI. They always have balanced budgets, but New York State is guilty of closing those deficits by borrowing, same problem.

Mr. LEWIS OF KENTUCKY. I just want to use my State as an example. Just as a matter of like 3 or 4 years ago, we had a $325 million surplus and——

Mr. HEVESI. I am sorry. In the late 1990s and into 2000 the State had surpluses.

Mr. LEWIS OF KENTUCKY. Sure. What happened to that surplus?

Mr. HEVESI. They were spent.

Mr. LEWIS OF KENTUCKY. Spent, absolutely spent.

Mr. HEVESI. We agree.

Mr. LEWIS OF KENTUCKY. So I think the problem here that it is not that we are not having a problem with taxes, we are having a problem with spending. I want to ask you, what would be your way to get us out of deficits and out of this slowdown in the economy? Would it be to increase taxes?

Mr. HEVESI. Well, no. I wouldn't cut the taxes that are now in this proposal.

Mr. LEWIS OF KENTUCKY. So you would do nothing?

Mr. HEVESI. Let me respond. The theory that the tax cuts will drive the economy may have some validity if, as you suggest—and I agree with you—that the spending reductions were commensurate. If you lost revenue but you reduced your spending, then the stimulant effect is very positive. If you reduce your tax revenues and maintain your spending or increase it and fill that vacuum with debt, for a couple of years you will have a nice cash flow.

Mr. LEWIS OF KENTUCKY. How much——

Mr. HEVESI. You are going to have to pay that debt back and that is going to eat into——

Mr. LEWIS OF KENTUCKY. How much is New York State cutting their spending?

Mr. HEVESI. Well, I am not the Governor or the legislature. They are flattening their spending for this year because of the crisis. The Governor has proposed $1.2 billion reductions in school aid, about $1.2 billion in health care, Medicaid costs. By the way, our Governor, who is opposed to any tax increases, has about $1.4 billion in tax and fee increases.

Mr. MCNULTY. I appreciate him for that.

Mr. HEVESI. No, no. Increases, you don't appreciate him for that.

Mr. MCNULTY. Oh, increases.

Mr. HEVESI. Increases.

Mr. MCNULTY. Increases in taxes.

Mr. HEVESI. Yes. He calls them fees. There is a sales tax increase. It is $1.4 billion in his proposed budget. Even the comment

about the 9 million seniors who are going to benefit, that is not the question itself. The issue is number one, how much are each of them going to benefit? What is the tax savings? I don't know that number and——

Mr. SCHAEFER. It is $936, call it a thousand.

Mr. HEVESI. It is $936?

Mr. SCHAEFER. On average.

Mr. HEVESI. On average, good. I am not an attorney, so I asked the question even though I didn't know the answer. That is an offset if the same senior finds, because of the general economy and because of their local taxes go up, their property taxes go up, their sales tax go up, their State income tax goes up, or they lose their senior center, or they lose the rent exemption that they had before.

Mr. LEWIS OF KENTUCKY. So you are saying government can spend individuals' and families' money and income better than they can? That is what you are saying.

Mr. HEVESI. No, no. I think that American—I have heard this many times, and I don't want to get into partisan exchange. I think the public asks its government to provide things. I think when the President sends 250,000 troops to Iraq, he didn't ask each American, "Is this money well spent?" He said, "This is going to be spent because this is what I believe in," and that is going to be very—does President Bush think that he knows better how to spend money in Iraq and in Afghanistan better than the American voter? I mean they——

Mr. LEWIS OF KENTUCKY. According to the polls of the American people——

Chairman THOMAS. The gentleman's time has expired, and the nonpartisan comment was registered. Does the gentlewoman from Ohio wish to engage the Comptroller in a nonpartisan discussion?

Ms. TUBBS JONES. At some point, Mr. Chairman, but I am going to start somewhere else and come back to the nonpartisan engagement. I want to start with Mr. Keating. Mr. Keating, good afternoon, and good afternoon to all of the panel and thank you for hanging around so long.

A lot of people don't realize that the insurance industry plays an important role in the area of retirement planning and security. One of the purposes of this series of hearings is to figure out some of the unintended consequences of the President's economic proposals and the legislation introduced to enact it.

With that in mind, can you tell me how the dividend proposal as it stands now will have an adverse effect on retirement security? Mr. Keating, understand I only have 5 minutes. My question was a little long, so your answer can be a little less long.

Mr. KEATING. I will be very brief.

Ms. TUBBS JONES. Okay.

Mr. KEATING. As one who recently purchased a variable annuity, not because I was going into this industry, but because I am at the age where I need to think about some kind of defined benefit, if you will, from the private sector to take care of me and my spouse. That annuity is filled with mutual funds, or will be filled with mutual funds.

If the President's proposal is enacted, our industry fully supports that because we think you will have more savings, more investment, more income, more job growth as a result.

Ms. TUBBS JONES. That part I didn't want to hear. Go ahead, I am kidding.

Chairman THOMAS. Tell the gentlewoman to relax. We don't have to really worry about the clock. There is no one else here.

Ms. TUBBS JONES. Just me and you?

Chairman THOMAS. It is just me and you, and the gentleman from New York.

Mr. KEATING. If that proposal is enacted without adjustment to the life insurance piece, what you have is a situation where mutual funds outside of an annuity are tax free and mutual funds like I purchased in the annuity, are fully taxable. So guess what? I would sell the annuity, perhaps at a loss. What will that do? Well, there are 72 million annuities in effect in the United States. Many of those are in qualified plans. Many of those are nonqualified plans. People, as they get older, invest in an annuity, want that defined benefit, that assurance of an income stream to take care of them as a companion to Social Security. That entire industry, according to Bear Stearns, would be in flames, would be wrecked, if there were not the opportunity to treat the mutual funds in the annuity with the same tax free status as the mutual funds outside of the annuity. That is why we think consistent treatment should be applied, as a social policy, considering the older baby boomers of my age group have on the average only $47,000 of cash assets. You throw in your retirement plans, you throw in your house, maybe $120,000 or $130,000. You need a lot more money to take care of people in their old age in addition to Social Security, and we provide that opportunity.

Ms. TUBBS JONES. Thank you, Mr. Keating.

Mr. Schaefer, my question for you is do you believe that if you did a survey of the senior citizens that you are worked about having to forego $936, if they had an opportunity to receive a prescription drug benefit without paying any money out of their pocket, any more than $25 per month, that they would forego that $936 and be interested in a prescription drug benefit?

Mr. SCHAEFER. That would be a speculation on my part to answer that, not knowing what the per capita cost of the plan you are talking about, so——

Ms. TUBBS JONES. Mr. Schaefer, all of the stuff you wrote in here is speculation, and you know it. In fact, all we have been doing all day is speculating because we have no idea what is going to happen with this economy. We have been sitting here talking about give money back to the business, cut the tax, do all of these different things——

Mr. SCHAEFER. I think——

Ms. TUBBS JONES. Let me finish. Do all of these different things, and we are going to have a better economy in which people are going to spend their money and go out and consume, et cetera. Now, that is all speculation, sir. So now that you have speculated for a while, let me speculate, and if you cannot answer my question, tell me so.

Mr. SCHAEFER. I think there is a broad range of issues that seniors would be concerned about, including prescription drugs. There is no doubt about it.

Ms. TUBBS JONES. They would in fact forego $936 a year if they could have all of those benefits.

Mr. SCHAEFER. I am not sure you can come to that conclusion. Some may. Some may not, but we should basically let them make the decision and give them back their tax money.

Ms. TUBBS JONES. Well, that is your position.

Mr. SCHAEFER. They can decide what to do with it.

Ms. TUBBS JONES. Anyway, how many of the——

Mr. SCHAEFER. I think what we are trying to talk about is creating jobs.

Ms. TUBBS JONES. Mr. Schaefer, my question. Mr. Schaefer, my question, and if you don't want to deal with my question, tell me and I will ask somebody else a question, okay?

Mr. SCHAEFER. Listening.

Ms. TUBBS JONES. You talk about 9.8 million seniors. How many seniors are there in this country, sir?

Mr. SCHAEFER. I don't have the number. That are age 65 and older, what percentage that would be?

Ms. TUBBS JONES. It would be nice to figure that into that discussion because it would make your argument a little more legitimate if you could say how many 9.8 million represented.

Mr. SCHAEFER. Okay. We will get that to you for the record.

Ms. TUBBS JONES. You will get that answer for me, will you?

Mr. SCHAEFER. Yes, we will.

[The information follows:]

Securities Industry Association
Washington, DC 20005–2225
March 27, 2003

The Honorable Stephanie Tubbs Jones
United States House of Representatives
1009 Longworth House Office Building
Washington, DC 20515

Dear Congresswoman Tubbs Jones:

I am pleased to respond to the question that you posed to me when I testified before the Committee on Ways and Means on behalf of the Securities Industry Association on March 5, 2003, in strong support of the proposal to eliminate the double taxation of corporate earnings by providing an exclusion from the income tax for investors receiving dividends paid out of fully taxed corporate earnings.

You asked me for the number of people in the United States that are age 65 and older, in order to put in context my statement that 9.8 million seniors receive dividends. According to the United States Census Bureau, in the year 2000 just over 35 million individuals residing in the United States were age 65 or older (35,062,000) (midyear population). The U.S. Census Bureau projects that there were 35.3 million individuals in this group as of July 2002, and projects there will be 35.6 million as of July 2003. (*See* U.S. Census Bureau Annual Projections of the Resident Population by Age, Sex, Race, and Hispanic Origin: Middle Series, 1999 to 2100.) Using the July 2003 projection, roughly 27.5 percent of those age 65 and older receive dividends.

Sincerely,

John H. Schaefer
Chairman of the Board

Ms. TUBBS JONES. Thank you. Let me go to Mr. Hevsi. Let me say to you, sir, I am so proud that you would come here as a public official from the State of New York, even though New York has a huge capital market and insurance industry, because it speaks to the fact that those of us who are elected officials, even in the face of all those people who we hope will support us, that there are some times that it is necessary for you to step up on issues that are more important to your constituency than to a particular industry. My time looks to be up, but if you want to respond, I am sure the Chairman, since it is only me and him and the man from New York still here, that you might get a chance to say something.

Mr. HEVESI. Other than indicating my gratitude, I have no interest in responding.

Ms. TUBBS JONES. Okay. Thanks, Mr. Chairman.

Chairman THOMAS. Thank you. Just a couple of points for those of you who are suggesting changes that may cost revenue, I have always found that you shouldn't leave to other people the work that affects you, so if you can get to me as quickly as you can, especially Mr. Stack and Governor Keating.

Mr. STACK. Mr. Chairman, we will. We do strongly believe that it is less than the increase in borrowing costs for State and localities.

Chairman THOMAS. Thank you. I just want to assure any witness that ever appears before this panel, as long as I am Chairman, the questions may be the Members'. The answers belong to the witnesses.

I want to remind you that today's segment is a portion of an ongoing hearing, and the hearing is in recess if there be no further business before the Committee. We will reconvene on Tuesday for the third segment of our four-segment hearing. No, we will convene on Thursday, tomorrow, at 10:00 a.m. for the third of the four-segment hearing.

[Whereupon, at 5:48 p.m., the Committee was recessed, to reconvene at 10:00 a.m., Thursday, March 6, 2003.]

PRESIDENT'S ECONOMIC GROWTH PROPOSALS

THURSDAY, MARCH 6, 2003

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 10:05 a.m., in room 1100 Longworth House Office Building, Hon. Bill Thomas (Chairman of the Committee) presiding.

Chairman THOMAS. Good morning. Today marks the third day of a four-part hearing to examine the President's initiative to promote economic growth while creating jobs for every worker who wants one.

We will begin today by again focusing on the proposal to eliminate the double taxation on stock dividends, which seems to be a major theme regardless of what the panel was supposed to talk about over the last several days. We are going to hear reaction from experts also on low-income housing and pensions and retirement savings, the other side of the coin from the stock dividends proposal.

Joining us as soon as his plane lands, I believe, is John Makin, a Resident Scholar and Director of Fiscal Policy Studies at the American Enterprise Institute; Dallas Salisbury, President and CEO of the Employee Benefit Research Institute; Douglas Shackelford, Meade H. Willis Distinguished Professor of Taxation at the University of North Carolina; and Richard Godfrey, Executive Director of the Rhode Island Housing and Mortgage Finance Corporation and Vice President of the National Council of State Housing Agencies.

Thank you for being with us this morning.

As with the previous two hearings, the experts will bring to us several perspectives and hopefully possible alternatives so that we can examine all of these issues with the pros, the cons and the alternatives in front of us.

As usual before we start, I would like to recognize the gentleman from New York, Mr. Rangel, for any comments he may wish to make.

[The opening statement of Chairman Thomas follows:]

Opening Statement of The Honorable Bill Thomas, Chairman, and a Representative in Congress from the State of California

Good morning. Today marks the third day of a four-part hearing to examine the President's initiative to promote economic growth while creating jobs for every worker who wants one.

We will begin today by again focusing on the proposal to eliminate the double taxation on stock dividends. We are also going to hear reaction from experts on low-income housing, and pensions and retirement savings. Joining us today are John Makin, a Resident Scholar and Director of Fiscal Policy Studies at the American Enterprise Institute; Dallas Salisbury, President and CEO of the Employee Benefit Research Institute; Douglas Shackelford, the Meade H. Willis Distinguished Professor of Taxation at the University of North Carolina; and Richard Godfrey, Executive Di-

rector of the Rhode Island Housing and Mortgage Finance Corporation and Vice President of the National Council of State Housing Agencies. Welcome, we are pleased to have you with us this morning.

As with the previous two hearings, these experts bring to the Committee several perspectives and possible alternatives to the issues for us to consider.

Before we get started, I would like to first recognize the gentleman from New York, Mr. Rangel, for any comments he would like to make.

Mr. RANGEL. Thank you, Mr. Chairman. I am anxious to hear from the witnesses. I join with you in thanking them for attending, and I yield back the balance of my time.

Chairman THOMAS. Thank you. All of your written statements will be made part of the record. You can address us in the time that you have as you see fit. The microphones have an on-off switch. They are very unidirectional. If you will speak directly into them, we will have a better chance to hear you. Mr. Salisbury.

STATEMENT OF DALLAS L. SALISBURY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, EMPLOYEE BENEFIT RESEARCH INSTITUTE

Mr. SALISBURY. Mr. Chairman, Mr. Rangel and Members of the Committee, thank you very much. Thank you for inviting me today.

I have been asked to specifically focus on the impact of the dividend payment proposals on pensions and particularly defined contribution retirement plans. We believe the major impact of the family of dividend exclusion proposals on those plans would fall into three areas: The employers may terminate existing arrangements, employers that may have started a new plan had the proposals not been adopted, and employees that would be offered qualified plan coverage but choose to forego it in order to have nonplan investments in order to take advantage of the new dividend tax treatment.

There will obviously be some plan sponsors, particularly among small businesses, that are so close to the margin as to whether they should offer a qualified plan that when the after-tax financial outcome of the next best alternative based on these legal changes is presented to them it would be sufficient to tip the scales towards termination of a plan. Of course, the real concern is exactly how many of these plans are there and is the loss of benefits for their employees significant. There is no database that we are aware of that can provide this estimate, but this is one of the questions that needs to be answered before final analysis of such proposals can be provided.

It is unlikely that the vast majority of plan participants will see their plans terminated as a result of this proposal, since it is those with less than 10 and less than 25 employees that would most likely do that, and that segment of the labor force accounts for only approximately 16 percent of all employees.

Congress should not limit itself merely to existing plans. It is quite likely that there may be employers who would have started a new plan had the proposals not been adopted. However, we believe this would have a relatively short window effect as a result of the extra 2001 provisions that provided for 401(k) plans to allow

participants to choose to allocate all or a portion of their contributions to after-tax Roth contributions beginning in 2006. These provisions would allow an individual to fully escape taxation of interest income, dividend income and all capital gains income.

In addition to either causing the termination of existing plans or the suppression of new plans, the dividend exclusion proposals could also have impact on employees in their decision making. The list of decision variables in making individual choices is obviously specific to each individual, but some of the more important determinants are likely to be, first, after-tax versus before-tax contributions; second, the individual's expectations for tax rates over time; thirdly, the need to access money for emergencies or the perception of that need; and, fourth, whether or not the employer offers matching contributions.

Regardless of the impact on total savings, some workers are likely to lose the valuable ancillary benefits they derive from participates in an employer-sponsored plan.

In the post-Enron environment, legislation that your Committee and others have considered post-Enron, one cannot understate the importance of those particular considerations.

The dividend exclusion proposal is also likely to have an impact on IRAs, both regular and Roth.

In conclusion, Mr. Chairman, having done our own preliminary analysis and having read those produced by others, we are unable to make a point estimate as to the extent to which the dividend exclusion proposals would harm qualified retirement plans, as there are many alternative parameters.

Our latest Issue Brief notes 18 percent retirement plan participation among employers with less than 10 employees in 2001 for those workers who are prime age. This figure has increased by 50 percent since 1991. There have also been dramatic increases in participation rates for the 10-to-24 and 25-to-99 employee firms, in sharp contrast to larger firms, where essentially participation has been flat. Are these groups big enough, enough people, to justify not doing something for all taxpayers that would be an automatic benefit for stock investors? That is the tough decision that you face.

However, if one were concerned with the potential termination problem, they could in fact mitigate it by accelerating the implementation date of the Roth 401(k) provisions to 2004 to coincide with the time when plan sponsors would first begin to consider the investment strategies and products likely to be created as alternatives to existing qualified plans. Small employers wanting sheltered income and increased appreciation and also wanting total tax exemption would be able to use the Roth 401(k) as opposed to plan termination and separate investment.

Mr. Chairman and Members of the Committee, thank you for your invitation again to testify.

[The prepared statement of Mr. Salisbury follows:]

Statement of Dallas L. Salisbury, President and Chief Executive Officer, Employee Benefit Research Institute

Introduction

- Thank you, Mr. Chairman, for allowing me this opportunity to share observations on how the president's plan to end double taxation of many dividend payments would impact America's pension system.

- A brief comment on terminology: I am including the proposed dividend exclusion, deemed dividend treatment and the recent expansion to include annuities in my comments. I will refer to it generically as the "dividend exclusion proposal" below.

Analysis

- I believe the major impact of the dividend exclusion proposal on qualified defined contribution plans will focus on the following three areas:
  - Employers that may terminate existing arrangements
  - Employers that may have started a new plan had the proposal not been adopted
  - Employees that would be offered qualified plan coverage but choose to forgo it for non-plan investments
- There will obviously be some plan sponsors (particularly among small businesses) that are so close to the margin as to whether they should offer a qualified plan that when the after-tax financial outcome of the next best alternative (i.e., have the owner forgo any contributions and declare a bonus for himself of an equivalent amount) improves via dividend exclusion it would be sufficient to tip the scales towards termination of the plan. I do not mean to imply that personal enrichment is the only reason that qualified retirement plans are offered by small employers. However, the mathematics of the cost/benefit tradeoff for a large number of small plans may be sufficiently modified to result in a significant number of terminations. Of course the real concern is exactly how many of these plans are there and is the loss of benefits for their employees significant? There is no database that I am aware of that can provide this estimate but this is one of the questions that needs to be answered before final analysis of this proposal can be provided.
- It is unlikely that the vast majority of plan participants will see their plans terminated as a result of this proposal. However, one should not minimize the potential problems that may be faced by a plan sponsor since non-highly compensated employees may choose (logically or otherwise) to opt out of a 401(k) plan in favor of non-qualified investments which may make ADP testing more difficult. Although it is also possible that the dividend proposal will make ADP testing easier as the highly compensated employees are more likely to contribute to the match level and then invest outside than the average employee stop investing and invest on the outside.
- Congress should not limit its concern merely to existing plans however as it is quite likely that there may be employers that would have started a new plan had the proposal not been adopted. However, I believe this would have a relatively short window as a result of the EGTRRA 2001 provisions that provided for 401(k) plans to allow participants to choose to allocate all or a portion of their contributions to after-tax "Roth contributions" beginning in 2006 and escape taxation on either principal or investment income when benefits are received. It would appear that many plan sponsors may find the Roth 401(k) to be a better option than forgoing a qualified plan and taking advantage of the dividend exclusion. I believe many potential sponsors would not choose to make contributions on an after tax basis just to get a dividend exclusion when they can get a full tax exemption under a Roth 401(k) plan.
- While the employer is under no requirement to allow participants to make after tax Roth contributions, it is likely that both Roth and traditional 401(k) provisions would be provided by most sponsors (especially among small employers) in an attempt to optimize benefit delivery for all of the employees. This results from the fact that some employees anticipate their marginal tax rate will increase between now and eventual time of payment (in which case a Roth contribution is preferable) while others anticipate it will decrease and therefore prefer a traditional 401(k) contribution.
- In addition to either causing the termination of existing plans or the suppression of new plans, the dividend exclusion proposal could also impact employees that would still be offered qualified plan coverage but choose to forgo it for non-plan investments. The list of decision variables in making this choice is obviously specific to each individual but some of the more important determinants are likely to be:

  1. after tax vs. before tax contributions (both from a financial and psychological perspective)
  2. the individuals expectations for tax rates over time
  3. the need to access money for emergencies
  4. whether or not the employer offers a match

- Regardless of the impact on total savings, some workers are likely to lose the valuable ancillary benefits they derive from participating in an employer-sponsored retirement plan. Some workers will end up investing in "individual" individual accounts as opposed to group (or employer-sponsored) individual accounts either due to the considerations mentioned above or because the employer has chosen not to sponsor a plan in the new environment. These individuals may lose the benefit of having a fiduciary screen for "appropriate" investments and continually monitor the funds. Moreover, employer-sponsored educational programs would likely not be provided, at least to the same extent, if the employee were to save outside of the qualified market. This could also result in higher investment and service fees, which would serve to lower overall retirement wealth.
- The dividend exclusion proposal is also likely to have an impact on IRAs—both regular and Roth versions. The rationale for the likely decrease in future contributions to these vehicles is that investors in IRAs who won't see the tax benefits for years might shift more money into taxable accounts. The latter would have the benefit both of tax free dividends as well as capital gains taxed at only a 20 percent rate. However, this is unlikely to impact a large percentage of individuals as only 5.3 percent of workers contributed to a deductible IRA in 1998.

Conclusion

- Mr. Chairman, having done our own preliminary analysis and having read those produced by others, we are unable to make an estimate as to the extent to which the dividend exclusion proposals would harm qualified retirement plans as there are too many unknown parameters.
- EBRI's latest Issue Brief notes 18% retirement plan participation among employers with less than 10 employees in 2001. This figure has increased by 50 percent since 1991. There have also been dramatic increases in participation rates for the 10–24 and the 25–99 employee firms and is in contrast with their larger firm counterparts that displayed only minor increases. Are these groups big enough (enough people) to justify not doing something for all taxpayers that would be an automatic benefit for stock investors—not something that requires action?
- However, if one were concerned with the potential termination problem they could mitigate it by accelerating the implementation date of Roth 401(k) plans to 2004 to coincide with the time when plan sponsors would first begin to consider the investment strategies and products likely to be created as a result of the dividend exclusion proposal as a viable alternative to qualified plans. Small employers want sheltered income and increased appreciation and also want total tax exemption. In which case the Roth 401(k) would be a more attractive alternative to the small plan sponsor.

Thank you, Mr. Chairman, for allowing me this opportunity to share observations on how the president's plan to end double taxation of many dividend payments would impact America's pension system.

It is bold as a move in policy. This is particularly true when it is combined with the savings proposals for LSA, RSA, and the Roth 401(k) acceleration to 2004. These last provisions essentially allow low- and moderate-income individuals to save with a 0% tax rate on interest, dividends, and capital gains. These are the groups most likely to own mutual funds versus individual securities, and the most likely to have money in regular savings accounts versus other vehicles due to their low savings rates. Total exclusion would not likely move them toward the purchase of dividend-paying stocks, but rather would create indifference.

It is likely to have only a limited impact in any direction on most current retirement and savings plan participants. Once the Roth 401(k) is in place in 2006, under current law, this becomes even more the case. A future exclusion from any taxes on any income or capital gains will clearly trump a stand-alone dividend exclusion. Some small employers could decide to not have a plan and simply move their money into a portfolio of high-dividend stocks. However, the Roth 401(k) would provide a better means of exclusion for these individuals, since they could also exclude interest and capital gains income. Since the theory of ending a plan due to this provision means a willingness to save after tax-dollars, the Roth 401(k) can be seen as a reasonable alternative for first dollars. The small employer might then also contribute to an LSA for family members. Roth 401(k)s, LSAs, and RSAs would also be more attractive options to small employers than simply moving their money into high-dividend stock portfolios.

It is unlikely that a dividend tax exclusion would lead to significant asset shifting for most individuals. Most defined contribution plan participants have small account balances, as most Americans have little in savings. The Administration's proposal should not have an effect on lower-compensated workers, as these workers are unlikely to have saved enough at any one time to make a stock purchase worthwhile, and the tax deduction is going to far outweigh any savings in dividends over their lifetimes and at withdrawal time.

Even with a dividend tax exclusion, higher-compensated workers would still want an employer-sponsored retirement plan, particularly if there is a match. These workers can always diversify into bonds in the retirement accounts and stocks in nontax-favored settings. Furthermore, if the retirement plan fees are subsidized by the employer, this may mitigate the benefits of not having dividends taxed, since dividends are running around 2 to 3 percent of value.

It is unlikely the Administration's proposal will cause a large number of people to change the way they invest. It appears more to be just a tax "break" for stock owners, and for many it will be quite small. At this point it is uncertain whether this would really have an effect on mutual fund providers. If, at some point in the future, corporations decided to significantly increase their dividend payouts, this analysis would change. But that is unlikely (certainly in the current economic environment), and stock appreciation will always be important.

The savings proposals will discourage targeted retirement savings, however. For employees not participating in a 401(k) plan offering an employer match, the LSA would often be the first place to put the first $7,500 per family member due to the lack of restrictions on when a participant can take a distribution as well as the lack of early withdrawal penalties. Since this amount is more than most Americans save in a year in any form,[1] it could absorb all savings for most.

It is a next step in a long-term policy progression toward incentives for savings other than for retirement. Until the mid 1990s the incentives were offered for retirement savings only. These incentives were often reinforced through early withdrawal penalties and, in the case of certain 401(k) monies, in-service withdrawals were permitted in only limited situations. The Taxpayer Relief Act of 1997 created a new tax-favored savings vehicle called a Roth IRA that introduced the concept of "no deduction," "no tax on withdrawal" to retirement planning.[2] Then came 529 plans for college savings, Individual Development Accounts, etc. Now, the proposed Lifetime Savings Account would allow for withdrawal for any purpose without tax or penalty at any time.

It is likely that there will be two groups that would forego the LSA for at least a portion of their annual savings. First, those who have a retirement plan at work with a matching contribution and are willing to have limited access to the money are likely to choose to participate in the 401(k) plan instead. Second, those motivated by the ability to make before-tax contributions to have an immediate tax reduction would likely prefer the 401(k) plan also. This latter group is likely to be high-income individuals who believe they will be in a higher tax bracket when they withdraw the money or intend to leave the account to their non-taxable estate.

The savings proposal could cause some small employers to terminate retirement plans and others not to start them. This is especially likely to happen with small plans, since the employer could put away $15,000 for him/herself with similar amounts for a spouse and each child without having to deal with administrative details of qualified plans or the employer contributions necessary to make a safe-harbor 3% contribution, a safe harbor matching contribution, or to induce sufficient contributions from the NHCEs to pass the nondiscrimination tests. Moreover, at least initially, the $15,000 is greater than the $12,000 under Sec. 402(g), which would still apply to ERSAs.

Certain elements of the savings proposal would work toward increasing total savings. First, the LSA and the RSA would apply to all persons with identical provisions so that advertising them would be easy and clear and much confusion

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[1] In the calendar year 1999 data from the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project, the average before-tax 401(k) participant contribution as a percentage of salary was 6.8 percent. The average total participant contribution as a percentage of salary was 6.9 percent. Based on an average annual participant salary of $44,187, this produces an average annual before-tax contribution of $3,004, or $3,048 if after-tax contributions are included. See Sarah Holden and Jack VanDerhei, "Contribution Behavior of 401(k) Plan Participants." ICI *Perspective,* Vol. 7, no. 4; and *EBRI Issue Brief* no. 238 (Investment Company Institute and Employee Benefit Research Institute, October 2001).

[2] Technically, after-tax contributions and recovery of the cost basis tax-free were quite common before 401(k) plans. However, Roth IRAs also allow for tax-free withdrawal of investment income.

would be eliminated. The universal eligibility and relatively simple design of the attendant financial instruments should increase both the supply and demand for these options. Second, the increased flexibility with respect to withdrawal access should also appeal to those with limited resources who prefer to have ready access to liquid assets in the case of financial emergencies.[3] Third, taxpayers who believe their personal long-term tax rates will increase would find the after-tax nature of the LSA and RSA desirable and might choose to increase their annual savings as a result.[4]

However, there are also reasons to hypothesize that the savings proposal may not increase total savings. First, most taxpayers already have both the regular IRA and the Roth IRA available but few have chosen to contribute to either.[5] Given that Roth IRAs need to satisfy a five-year holding requirement that does not apply to LSAs, there may be more of a demand for the latter, but it might simply capture short-term savings. Second, if the proposal were adopted, it would likely lead to termination of existing defined contribution plans, especially among the small employers. Since employee contributions are mostly driven by matching employer contributions,[6] this would not only deprive a significant number of employees from receiving employer contributions, but it would likely cause them to discontinue their own contributions as well.

Regardless of the impact on total savings, some workers are likely to lose the valuable ancillary benefits they derive from participating in an employer-sponsored retirement plan. Some workers will end up investing in "individual" individual accounts as opposed to group (or employer-sponsored) individual accounts either due to the considerations mentioned above or because the employer has chosen not to sponsor a plan in the new environment. These individuals may lose the benefit of having a fiduciary screen for "appropriate" investments and continually monitor the funds. Moreover, employer-sponsored educational programs would likely not be provided, at least to the same extent, if the employee were to save outside of the qualified market. This could also result in higher investment and service fees, which would serve to lower overall retirement wealth.

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Chairman THOMAS. Thank you very much, Mr. Salisbury. Mr. Shackelford.

STATEMENT OF DOUGLAS A. SHACKELFORD, MEADE H. WILLIS DISTINGUISHED PROFESSOR OF TAXATION, UNIVERSITY OF NORTH CAROLINA, CHAPEL HILL, NORTH CAROLINA

Mr. SHACKELFORD. Mr. Speaker and distinguished Members of this Committee, I support fundamental reform of the taxation of financial capital, including the elimination of double taxation, not because it will provide a significant immediate stimulus to the economy, which I doubt it will, but for its long-term efficiency gains.

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[3] Holden and VanDerhei show that a participant in a plan offering loans was expected to contribute 0.6 percentage point more of his or her salary to the 401(k) plan than a participant with no borrowing privileges. Sarah Holden and Jack VanDerhei, "Contribution Behavior of 401(k) Plan Participants."

[4] There are many reasons why an individual taxpayer may believe their tax bracket would increase later in life even if the tax rates remain static. However, growing budget deficits (and the promises for Medicare and Medicaid already in law for the elderly), which are growing rapidly, may provide additional incentive for individuals to choose the after-tax contributions.

[5] Only 5.3 percent of workers contributed to a deductible IRA in 1998. Craig Copeland, "IRA Assets and Characteristics of IRA Owners," *EBRI Notes,* no. 12, (December 2002).

[6] Jack VanDerhei and Craig Copeland. "A behavioral model for predicting employee contributions to 401(k) plans." *North American Actuarial Journal* (First Quarter, 2001).

However, the President's proposal for eliminating double taxation is unduly complex. To illustrate, let me ask you, how are you going to answer a constituent who asks, will not 2003 dividends be taxed?

I think you will have to say something like this: It depends. You see, 2003 dividends are not taxed to the extent the company had taxable income less taxes in 2001. So if 2003 dividends exceed 2001 after-tax taxable income, then you are subject to tax on the excess amount.

If the company's dividends are less than 2001 after-tax taxable income, then your 2001 dividends are exempt and you may receive tax-free dividends in the future unless the company opts to increase your tax basis, which it may do at any time during the year, in which case your capital gains will be less when you sell the stock, assuming, of course, you maintain records of these increases in tax basis over the years. These provisions, however, only apply if you hold the stock for at least 46 days. Otherwise, you face the usual full dividend and capital gains taxation.

That is the simple answer.

Things will get more complicated after 2003, because we have to track after-tax taxable income and dividends on a cumulative basis. So in 2004 dividends might be fully exempt, even though 2004 dividends exceed 2002 after-tax taxable income. However, this will result in shareholders having to decrease the tax basis they increased in 2003.

Under no condition would I recommend that you mention what happens if there is an IRS audit or there are carry-overs, the AMT, the foreign tax credit.

Now, why is the President's bill so complicated? The complexity arises from the lofty goal of attempting to link corporate and shareholder taxes. Unfortunately, it is impractical.

I would like to advance an alternative that will eliminate double taxation and vastly simplify the Tax Code. Retain full taxation of dividend income, just as we fully tax interest income, but permit corporations to deduct dividends, again, just as we permit them to deduct interest. In other words, simply make debt and equity identical from a tax perspective.

Now, I believe this would have at least five advantages: First, it will eliminate double taxation. Second, it will reduce complexity in the tax law, not increase it as under the President's proposal. Third, it will eliminate inefficiencies that arise from these debt-equity differences, such as exotic securities from Wall Street. Fourth, it will substantially reduce the inefficiencies in the choice of organizational form—that is, choosing between operating through a C corporation, where there is both investor and entity taxation, versus an S corporation or partnership, where there is only investor taxation. Fifth, I believe it will improve corporate accountability and governance, because large institutional investors who would receive no direct benefit under the President's plan will be able to pressure managers to distribute free cash flow.

So what are the problems with deductibility?

One, it doesn't look good. Companies, not shareholders, reduce their taxes. Now, ignoring the problems with that claim, and there

are plenty, I accept that some may characterize deductibility as corporate welfare.

The other problem is the revenue estimates might claim it is too expensive, and I believe that costs are an important consideration in this proposal. However, it is very difficult for revenue estimates to fully capture the efficiency gains of simplification.

Nevertheless, if you are troubled by those concerns, then I recommend another option that will still eliminate double taxation, still simplify the code and still improve efficiency. Let us have no dividend deduction, let us have no dividend taxation, let us have no interest deduction, and let us have no interest taxation. This will shift tax payments from the investors to the company and should score better with the revenue estimators.

In summary, I applaud the President and you for tackling a very important problem; and let me emphasize the importance of the issue. Even tweaking the taxation of dividends—and the President's bill does far more than just tweak—carries major implications for a host of issues throughout the Tax Code. Unfortunately, the President's plan is impractical. However, there is a straightforward way to eliminate double taxation; and I urge you to do it.

I look forward to your questions.

[The prepared statement of Mr. Shackelford follows:]

Statement of Douglas A. Shackelford, Meade H. Willis Distinguished Professor of Taxation, University of North Carolina, Chapel Hill, North Carolina

Introduction and Summary

Mr. Chairman and distinguished members of the committee, I appreciate the invitation to comment on the provisions in the *President's Economic Growth Proposal* designed to eliminate the double taxation of corporate earnings.

The President has proposed reducing shareholder taxes by providing an exclusion for dividend income and a deemed dividend basis adjustment for capital gains. The proposal restricts these dividend and capital gains tax reductions to companies that pay Federal taxes. Linking shareholder and corporate taxes has intuitive appeal because it attempts to ensure at least one level of taxation. However, practically it will be extremely difficult to implement. In short, although I support the President's goal of no more than one level of tax on equity capital, the current proposal is unduly complex.

The purpose of reforming equity capital taxation should be to eliminate any distinctions between equity and debt capital. Currently dividend payments are not deductible to firms while dividend income is taxed to the recipients. This treatment contrasts with that of debt capital where interest expense is deductible and interest income is taxed. The reason equity capital is considered "double taxed" is this debt/equity distinction, i.e., the failure to permit companies to deduct dividends. I recommend eliminating any distinctions between debt and equity by taxing equity capital in the same manner as debt capital. That is, permit companies to deduct dividends and retain full dividend taxation.

The remainder of this written statement discusses why double taxation exists, details the complexity of the President's proposal, proposes a dividend deductibility alternative and identifies its possible weaknesses, conjectures about the stock market effects of the President's proposal, and mentions the importance of a global analysis.

Why Double Taxation Exists

Double taxation exists because debt and equity capital are taxed differently. The fundamental problem is that returns from equity are taxed twice, first at the corporate and then at the individual level, either as dividends or capital gains taxes. Conversely, debt capital is only taxed at the lender's level because borrowers are permitted a deduction for interest. This treatment implies that payments on one form of financial capital (debt) are a cost of doing business while payments on another (virtually identical) form of financial capital (equity) are not a cost of doing

business. This legal, but not economic, distinction between debt and equity has led to considerable mischief in the tax law.

Differential taxation of capital sources has been examined for decades. Seminal work by Modigliani and Miller (1963) concludes that, in a world with corporate taxes, the solution to firms' maximization problem is to issue all debt, since interest payments are deductible, but payments on equity financing are not. In a major 1992 study, the Treasury Department concluded:

> "the current tax system often perversely penalizes the corporate form of organization, . . . distorts corporate financial decisions in particular by encouraging debt, . . . prejudices corporate decisions about whether to retain earnings or pay dividends and encourages corporations to distribute earnings in a matter to avoid the double-level tax."

By affording different treatment to different sources of capital, taxation becomes a factor in the choice of organizational form. Currently, C corporations are the only businesses that face two levels of tax, one at the entity level and another at the investor level. Sole proprietorships, partnerships, S corporations, and limited liability companies only face taxation at the investor level. Thus, many taxpayers operate their businesses under these forms to escape an additional layer of tax. Consistent with these tax incentives, Plesko (2003) documents a dramatic increase in the use of S corporations after the enactment of the Tax Reform Act of 1986. In short, many firms sacrifice the benefits of organizing as a C corporation (easy ownership division, unlimited life span, access to the public equity markets, among others) to eliminate their exposure to an additional level of tax.

Unfortunately, the President's proposal fails to treat equity and debt capital the same. It proposes retaining interest expense deductibility, interest income taxation, and non-deductibility of dividend payments, while (under certain conditions) providing an exemption for dividend income. To really reform financial capital taxation, using the President's approach, would require linking corporate profits to the taxation of interest income, a proposal that no one has advanced. In other words, if linking shareholder taxes to corporate taxes is appropriate, the law should also link bondholder taxes to corporate taxes. To address the debt/equity asymmetry underlying double taxation, a proposal that provided tax-exempt dividends if companies pay taxes should also recommend exempting interest income if leveraged firms pay corporate taxes.

Complexity in the President's Proposal

The complexity in the President's proposal arises from linking shareholder taxes to corporate taxes. The intention is to ensure that corporate profits are taxed at least once, either at the corporate level or at the shareholder level.[1] While a lofty goal, linking corporate taxes and shareholder taxes introduces enormous complexity as numerous commentators have noted, including Paul Krugman, who termed the proposal, "The Tax Complication Act of 2003."

To illustrate a bit of the complexity, consider the fact that the proposal will not tax 2003 dividends to the extent the company had after-tax profits in 2001. If 2003 dividends exceed 2001 after-tax corporate profits, then the excess is subject to tax. If 2003 dividends are less than 2001 after-tax profits, then 2003 dividends are exempt. Future dividends also may be tax-free or may be used to increase shareholders' tax bases at the discretion of the company. If the firm chooses to increase basis, which it may do at any time during the year, future capital gains will be lower, assuming, of course, shareholders maintain records of these increases in tax basis. These provisions, however, only apply, if the stock is held for at least 46 days. Otherwise, the current law with full dividend and capital gain taxation applies.

Those rules are just the basics. Complexity increases after 2003 because computations will be made on a cumulative basis. 2004 dividends might be fully exempt even though they exceed 2002 after-tax profits, if the firm had an excess of 2001 after-tax profits over 2003 dividends. However, this would result in a reduction in shareholders' tax bases. Other considerations include IRS audit adjustments to prior years, loss carryovers, and alternative minimum tax. As Bear Stearns (2003) stated in January "The proposal is a tax planning nightmare." Unfortunately, the complexity problem cannot simply be addressed with minor tweaks to the President's proposal because it arises from the attempt to link shareholder taxes to corporate

[1] Under current and proposed law, this goal is not possible as long as some shareholders (e.g., pensions, charities, or foreign investors) are tax-exempt. In those cases corporate profits escape all taxes if companies avoid taxes and pay dividends that would be fully taxable, except that the shareholders are not subject to tax.

taxes. Solving the complexity problem requires uncoupling the shareholder taxes from the corporate taxes.

An Alternative Approach—Dividend Deductibility

An alternative exists that could eliminate double taxation and not only avoid this complexity, but significantly simplify the tax code. Recall that the double taxation arises because debt and equity are taxed differently. The government could enact legislation to tax equity capital in the same manner that it taxes debt capital, permitting a deduction for dividend payments and fully taxing dividend income.

This is not an original idea. In 1984 the Treasury Department (so-called Treasury I) recommended that 50 percent of dividends be deducted. More recently, others (including columnists George Will, Allan Sloan, and Martin Mayer, and Senator Jon Corzine) have recommended dividend deductibility.

The rationale is as follows: Firms require financial capital to operate. Investors provide the capital because they believe the firm will earn a return that justifies its risk. Accountants attempt to dichotomize financial capital into debt and equity. However, sophisticated financial engineering often makes this dichotomization seem arbitrary. As evidence of the difficulty in discerning the difference between debt and equity, the IRS has yet to issue final regulations defining debt and equity for tax purposes, although instructed to do so by Congress in 1969. In short, it is difficult, at best, to discern whether financial capital is debt or equity. However, despite the lack of economic distinction between debt and equity, the tax law treats them differently. Since there is no economic justification for taxing debt and equity differently, I urge the committee to eliminate the current distinction and thereby eliminate double taxation.

Besides eliminating double taxation, identical treatment of both debt and equity will result in other benefits. It will eliminate tax-motivated deadweight costs that arise from the development of exotic securities that have equity features but receive debt taxation (high-yield bonds) or have debt features but receive equity taxation (e.g., trust preferred stock). Another positive by-product will be the removal of tax considerations from the choice of organizational form. Since C corporations are the only business form that is taxed both at the entity and investor level, taxing debt and equity the same would largely eliminate the unjustifiable differences between C corporations and other organizational forms (e.g., sole proprietorships, partnerships, and other corporations, such as S and limited liability). Equal treatment would therefore remove tax considerations from organizational form choices.

A major non-tax by-product from this change will be improved corporate accountability and governance because large institutional investors (who receive no direct benefit from the President's plan because they already enjoy dividend exclusion) will benefit from deductibility. Consequently, they could apply pressure on corporate management (that millions of tiny individual investors cannot) and force them to distribute free cash flow, rather than retain and squander it. Unfortunately, with basis adjustment as an option to dividends, I anticipate the President's proposal applying little pressure on companies to distribute their cash.

Problems with Dividend Deductibility

One possible problem with deductibility is the appearance of unfair corporate welfare since deductibility reduces corporate taxes, but not shareholder taxes. However, this argument is flawed because the cost of equity will reflect returns to the shareholder after considering both corporate and shareholder taxes. So, while there may be an appearance problem, in reality, the return to shareholders is the same, whether they receive after-tax profits as tax-free dividends or face personal taxes on before-tax dividend payments.

Moreover, permitting C corporations to deduct dividends simply places them on similar footing with all other organization forms, such as partnerships and S corporations, which only tax business profits at the investor level. Since publicly-traded businesses are taxed under C corporate rules and most privately-held businesses use another organizational form (e.g., S corporation or partnerships) or eliminate corporate taxes through year-end bonuses or interest payments, the distinctive taxation for C corporations can be viewed as an added tax on accessing the public capital markets. Obviously, there is no justification for taxing companies that access the public capital markets differently from companies that access the debt capital markets.

A second objection could be that dividend deductibility is too expensive. This may be true and might argue against any legislative change, including the President's proposal. However, it is important to recognize that this charge could also be levied at the current treatment of debt capital where we permit interest expense to be de-

ducted, regardless of whether the interest income is subject to U.S. tax. Assuming we correctly deduct and tax interest, we should treat equity capital similarly. One option to reduce the cost of deductibility would be to permit only a percentage of interest and dividend payments to be deducted (as suggested under Treasury I) but to require all interest income and dividend income to be fully taxed. Another option to save money would be to achieve debt-equity equality by providing no deduction for dividend payments, no deduction for interest payments, no tax on dividend income and no tax on interest income.

However, before you allow revenue estimates to prevent you from appropriately reforming financial capital taxation, count the costs of complexity. One cost is the bewildered constituent, who grows cynical because he cannot understand why his taxes are so complex. The other (perhaps greater) cost is the untold deadweight costs on Wall Street and other streets as companies and investors undo (and sometimes exploit) legal distinctions that are inconsistent with economic reality. If you make dividends tax-exempt and continue to deduct and tax interest, as proposed under the President's plan, you beg bankers, lawyers, accountants and others to devise perfectly legal securities and structures that result in unforeseen consequences, including far greater revenue loss than currently anticipated.

Stock Market Reaction

Lurking in the background of the President's proposed changes to dividend and capital gains taxation is a hope that it will increase stock valuations. It is very difficult to predict stock price responses to tax legislation, although, at first blush, more favorable taxation of equity capital should increase the attractiveness of equity capital.

However, current tax policy has encouraged tax clienteles among shareholders that will need to be reshuffled to fully avail shareholders of the tax savings in the President's proposal. Recent research suggests that the marginal shareholder in dividend-paying companies faces low marginal tax rates [see Blouin (2003), Engle, Erickson and Maydew (1999), Frank (2002), Graham (1999), Kemsley and Nissim (2002), among others]. If so, these shareholders (e.g., institutions, such as pensions) will benefit little from the new legislation.

Conversely, the marginal investor in non-dividend paying firms (or low dividend-paying firms) appears to face high marginal tax rates and anticipate capital gains taxes on their returns to equity [see Lang and Shackelford (2000)]. These shareholders could benefit from tax-free dividends, but they must sell their current holdings in growth companies, pay the capital gains tax, and then reinvest in mature, dividend-paying firms. Their movement to tax-favored, dividend-paying firms might bid the stock price too high for the current, low-marginal tax rate shareholders of those companies. If so, the low-marginal tax rate investors would likely shift to the non-dividend paying firms, ignoring risk preferences, institutional restrictions (such as some pensions' inability to buy non-dividend paying firms), or transaction costs. Whether this reshuffling of the country's equity will occur and the pace at which it occurs is unclear; however, it will not be costless.

How Does this Affect Global Capital Markets?

It is beyond the scope of this statement to provide a complete analysis of the global capital market implications for the President's proposal or for dividend deductibility. However, I would urge the committee to think carefully about the implications of any changes on both foreign investors in U.S. companies and U.S. investors in foreign companies as well as the implications for U.S. and foreign competition in the market for corporate control.

Conclusion

In closing, I support the elimination of double taxation of corporate earnings. I urge the committee to address this fundamental problem by recognizing the inefficiencies created when debt and equity are taxed differently. Unfortunately, the President's proposal leaves debt and equity taxed differently and introduces enormous complexity. I recommend an alternative approach—either permit a dividend deduction in the same way that interest is deductible or remove all deductions and taxation of interest and dividends. In summary, if we are going to eliminate double taxation, which is definitely a worthy goal, let's do it right. Do not settle for an elimination of double taxation that still leaves debt and equity taxed differently.

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Chairman THOMAS. Thank you very much, Mr. Shackelford. Mr. Godfrey.

STATEMENT OF RICHARD H. GODFREY, JR., EXECUTIVE DIRECTOR, RHODE ISLAND HOUSING AND MORTGAGE FINANCE CORPORATION, PROVIDENCE, RHODE ISLAND, AND VICE PRESIDENT, NATIONAL COUNCIL OF STATE HOUSING AGENCIES

Mr. GODFREY. Thank you, Mr. Chairman, Representative Rangel and Members of the Committee. Thank you for the opportunity to testify today.

I am Richard Godfrey, Executive Director of Rhode Island Housing. I am also Vice President of the National Council of State Housing Agencies.

I come before you with great respect and only after deep consideration of the issues involved. I know that you are evaluating a tax plan that is intended to provide deeply needed economic stimulus to this country.

When the President first announced his plan to eliminate taxes on corporate dividends, my immediate reaction, along with the reaction of many in the housing industry, was concern, concern because so many of our programs are tax-driven. Instead of relying on appropriations, new, affordable apartment production, along with assistance for first-time home buyers, relies on tax incentives, tax incentives purchased by corporations that decide to invest in affordable housing solely because of financial incentives in the Tax Code.

However, we chose not to respond based on intuition. Instead, we are responding factually, basing our comments on the best educated estimate of the actual programmatic impact. We hired the best independent experts we could find, Ernst & Young, and charged them with determining the impact that the dividend tax exclusion will have on affordable rental housing production.

The news they brought back was devastating. Production would be cut 35 percent; 40,000 units of workforce and supportive housing would be lost every year.

The Housing Credit Program has been enormously successful. It has gained in efficiency and service to lower income working fami-

lies virtually every year. Organizations such as NCSHA and Rhode Island Housing have worked hard to accomplish this in an environment in which workforce and supportive housing are becoming ever harder to come by.

Between 1986 and 2000, inflation severely eroded the value of the Housing Credit. Two years ago you, Members of Congress, affirmed the importance of the Housing Credit by restoring the value lost to inflation and indexing it for future inflation. The currently proposed plan would negate your work, setting us back to the time prior to that inflation adjustment, instantly cutting apartment production by 35 percent annually.

Ernst & Young, through their well-substantiated econometric models, verified and enumerated our fears. The cuts would wound deepest where safe, affordable housing is hardest to produce: housing in urban areas, housing for the lowest-income families, housing in isolated rural areas.

In Rhode Island, as in many of our sister States, the Housing Credit program means far more than just affordable housing for working families. It means fewer families are homeless. It means children have a consistent and safe place in which to sleep, study, and go to school each day. It means parents have a secure place in which they can prepare for work. It means that homes are safe from lead paint and other life-threatening hazards.

Housing Credits build lives and communities, as well as just putting a roof over people's heads. There are neighborhoods and provinces where crime is down and property values are up because of Housing Credit investments. We used Housing Credits to renovate a critical mass of abandoned and derelict properties. This motivated other landowners to fix their properties as well. Once this beachhead is established, homeowners return, bringing true vigor and caring to places where previously everyone wanted to escape.

I invite you all to Rhode Island. I will take you to neighborhoods where, just a few years ago, there were blocks in which only one or two buildings were occupied. In those same blocks today, kids are playing, drug dealers are gone, and new homeowners and landlords join together for community planning and planting.

Many of you have been tireless supporters of the Housing Credit over the years. To my neighbor, Representative Johnson, particularly, we thank you for your endless support for the Housing Credit. Please do not send us back to the time before we got the inflation adjustment. In Rhode Island, rental housing prices are up 50 percent in just the past 4 years. Homelessness, driven by large increases among working families, has reached unprecedented levels. Homeless families now outnumber homeless individuals. Overcrowding has also increased 34 percent in the last decade. These phenomena are happening across the country, fueled solely by the lack of affordable rental housing.

How can America's economy grow without housing for its workers? How can our economy grow without a strong housing sector? You know that housing construction is one of the few bright spots in the economy last year. Our studies show that the Housing Credit now accounts for 40 percent of America's apartment construction. In Rhode Island, we know that every new unit we produce translates into one job in the construction industry. Ernst & Young esti-

mates that, nationally, apartment construction will be reduced by 40,000 units. That means 40,000 jobs lost along with 40,000 homes each and every year.

Thank you very, very much.

[The prepared statement of Mr. Godfrey follows:]

Statement of Richard H. Godfrey, Jr., Executive Director, Rhode Island Housing and Mortgage Finance Corporation, Providence, Rhode Island, and Vice President, National Council of State Housing Agencies

Mr. Chairman, Representative Rangel, and members of the Committee, thank you for the opportunity to testify on the impact of the Administration's dividend exclusion proposal on the Low Income Housing Tax Credit (Housing Credit) and the affordable rental housing production it makes possible.

I am Richard Godfrey, executive director of the Rhode Island Housing and Mortgage Finance Corporation. I am testifying on behalf of the National Council of State Housing Agencies (NCSHA). I serve as NCSHA's vice president.

NCSHA is a national nonprofit, bipartisan organization. It represents the housing finance agencies (HFAs) of the 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands.

NCSHA's member agencies administer the Housing Credit in every state. We also issue tax-exempt private activity housing bonds (Bonds) to finance Housing Credit apartments, other affordable rental housing, and first-time homes for low-income families.

NCSHA is deeply grateful to this Committee and the Congress for its steadfast support of the Housing Credit and Bonds. Over 85 percent of the Congress, including most members of this Committee, cosponsored legislation enacted just over two years ago to increase Housing Credit and Bond authority by nearly 50 percent annually. An even greater percentage cosponsored legislation making both programs permanent in 1993.

Eighty-two percent of the last Congress, including 34 members of this Committee, cosponsored Representatives Amo Houghton (R–NY) and Richard Neal's (D–MA) Housing Bond and Credit Modernization and Fairness Act, H.R. 951. We urge you to include this bill, re-introduced by Representatives Houghton and Neal this year as H.R. 284, in the tax bill you are preparing to write.

H.R. 284's enactment would extend the reach of the Housing Credit and Bonds by repealing the Mortgage Revenue Bond (MRB) Ten-Year Rule, updating MRB purchase price limits, and making Housing Credit income eligibility rules more flexible. The Ten-Year Rule alone is costing states over $3 billion annually in MRB mortgage money that would otherwise be available to help working families buy their first home. California forfeits over $1 million a day to the Ten-Year Rule.

The Unintended Adverse Impact of the Dividend Exclusion on the Housing Credit

NCSHA does not oppose the Administration's Growth and Jobs Plan or the dividend exclusion proposal it contains. We have no position on either. NCSHA also does not believe the Administration intends any harm to the Housing Credit or affordable rental housing production.

We are deeply concerned, however, that Housing Credit apartment production would be severely curtailed if Congress enacts the dividend exclusion as the Administration has proposed it. Ernst & Young's (E&Y) just-released study, *The Impact of the Dividend Exclusion Proposal on the Production of Affordable Housing*, substantiates our concern.

NCSHA commissioned the E&Y study to back up with sound, objective analysis our belief that Housing Credit apartment production would be eliminated or severely reduced as a result of the enactment of the dividend proposal. We have shared the report with the Committee and ask that it be made part of today's hearing record.

E&Y estimates that 40,000 fewer Housing Credit apartments would be produced annually if the dividend exclusion were enacted as currently structured. That means 35 percent of annual Housing Credit apartment production would be lost. And, about 80,000 low-income residents would not be served.

NCSHA fears the total impact may be much greater. E&Y does not take into account, for example, the impact of the higher interest rates on tax-exempt housing bonds that almost certainly will result from enactment of the dividend proposal.

Forty-two percent of Housing Credit apartments developed annually are financed with tax-exempt bonds.

E&Y finds that corporate Housing Credit investors—who account for 98 percent of Housing Credit equity raised annually—would either limit the amount of capital they invest in Housing Credits or lower the price they are willing to pay for them, reducing the amount of Housing Credit equity available to produce affordable rental housing.

Simply stated, Housing Credits would be worth less to corporate investors. With enactment of the dividend exclusion, the more taxes a corporation pays, the more income shareholders could receive tax-free from the corporation. Since Housing Credits reduce corporate taxes, they would also reduce the corporate profits available to shareholders tax-free. Corporations seeking to maximize shareholder benefits would find Housing Credits less attractive.

The bottom line—corporations may still invest in the Housing Credit, but they would probably invest substantially less for each dollar of Housing Credits than they do today. This price adjustment would be necessary to compensate shareholders for reducing their tax benefits.

With less Housing Credit equity available, developments would face significant financing gaps. More "soft financing," typically provided as very low-cost or deferred loans from public sources, would be needed to fill the gap, essentially replacing the lost Housing Credit equity. Otherwise, developments would be financially infeasible.

Unfortunately, soft financing has become increasingly scarce due to federal, state, and local budget constraints. Without substantially increased government funds—unlikely in today's budget environment—existing public funds would be called upon to provide more subsidy to fewer properties. The rest simply would not move forward.

Properties located in distressed low-income communities and high-rent markets are at the greatest risk. These developments qualify for more Housing Credits than other properties because Congress recognized they are especially difficult and costly to develop, but meet an essential need. These properties typically rely on Housing Credit equity to fund a larger share of their development costs. A proportional cut in equity investments would hurt these properties the most.

What's the Answer

Solutions to the threat the dividend proposal poses the Housing Credit are at hand. One remedy is to treat Housing Credits as taxes paid, much like the proposal treats the foreign credit. Other approaches may work as long as they do not negatively affect the value of the Housing Credit. We stand ready to assist the Committee in evaluating alternative approaches.

We implore the Committee to act quickly, however. Some corporate investors are already deferring Housing Credit investments pending congressional action. According to E&Y, this has destabilized the Housing Credit equity market and is likely to reduce affordable housing production in the short-term.

What's at Stake

America cannot afford the loss of a single affordable apartment, let alone 40,000 Housing Credit apartments annually. As of 2001, over seven million American renter families—one in five—suffer severe housing affordability problems. They spend more than half of their income on rent or live in substandard housing. Meanwhile, more than 150,000 affordable apartments are lost each year due to rent increases, abandonment, and deterioration.

In the face of this staggering need, the Housing Credit is the only significant producer of affordable rental housing. Since 1986, it has financed 1.5 million apartments for low-income Americans—working families, seniors, the homeless, and people with special needs all across the country. Each year, the Housing Credit finances 115,000 more affordable apartments.

Virtually all Housing Credit apartments are dedicated for 30 years or more at restricted rents to families with incomes of 60 percent of area median income (AMI) or less. Often, Housing Credit residents earn far less than federal income limits permit. In 1997, the GAO found the average Housing Credit resident earned 38 percent of AMI. A majority of Housing Credit properties are committed to low-income use for periods longer than 30 years, many for 50 years or more.

In my home state of Rhode Island, the Housing Credit has produced over 5,600 affordable apartments and accounts for an additional 325 apartments each year. With rents of about $500 a month, these apartments are homes to our store clerks, nurses' aides, and truck drivers.

Rhode Island's working families need the affordable apartments the Housing Credit provides now more than ever. Between 1998 and 2002, the average rent for a two-bedroom apartment in Rhode Island increased 40 percent. Income growth has not begun to keep pace.

The Housing Credit in Rhode Island, however, does so much more than provide affordable rental housing. From the renovation of former mill housing in Westerly, bordering Representative Nancy Johnson's (R–CT) home state of Connecticut, to the conversion of a former factory in Cumberland, bordering Representative Neal's home state of Massachusetts, the Housing Credit revitalizes neighborhoods. I know from my HFA colleagues that the Housing Credit is helping to rebuild communities like these all across the country.

Congress Had the Right Idea

Congress understood when it created the Housing Credit that affordable apartments would not be produced without it or some form of tax incentive or subsidy. Apartments simply cost too much to build to rent at rates affordable to low-income households.

At the time, Congress took a remarkable, bold new approach to dealing with the low-income housing shortages that afflict almost all parts of our country. Rather than create another Washington-knows-best, one-size-fits-all program, you empowered the states to determine how to respond best to their housing needs. Rather than build another top-heavy Washington program bureaucracy, you entrusted the states to administer it, with rational IRS regulation and oversight. Rather than rely on the uncertainty of federal appropriations, you harnessed the resources of the private sector to capitalize it.

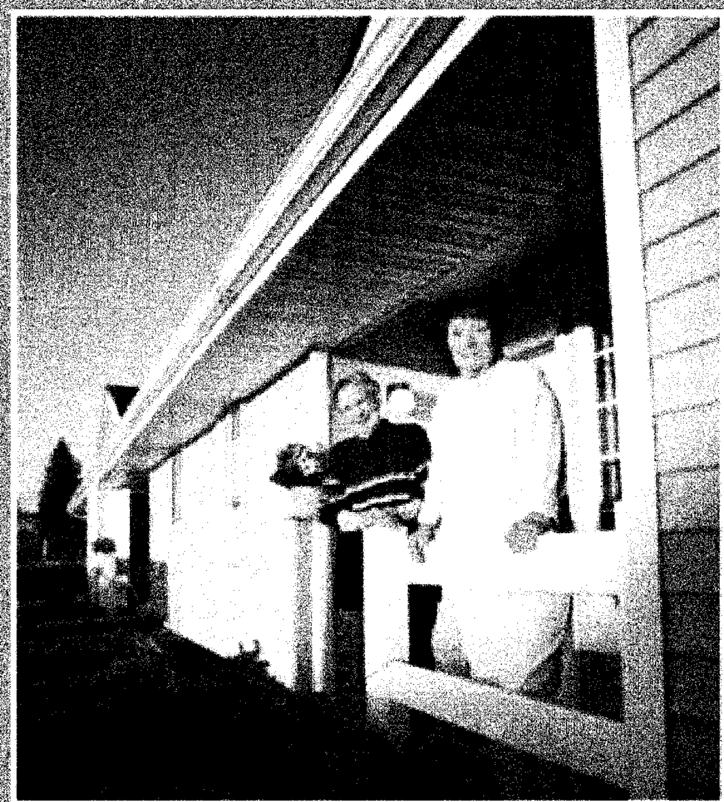
Today, the Housing Credit produces high quality, privately owned affordable rental housing in the parts of the country where it is most needed. This housing is built with $6 billion in private sector capital annually through highly effective public-private partnerships.

The Housing Credit has become more and more efficient over time, due in large part to both Congress's 1993 decision to make the Housing Credit permanent and increased corporate investment. Prices investors pay for Housing Credits have risen approximately 50 percent since the program's creation in 1986, increasing the amount of private sector equity capital that goes directly into affordable housing production.

The Housing Credit is not just good for housing; it is good for the economy. Housing Credit apartments account for up to 40 percent of all apartment production annually. Each year, the construction and operation of Housing Credit properties generates approximately $8.8 billion of income for the economy, creates 167,000 jobs, and produces $1.35 billion in revenue for cash-strapped local governments. In just my small state of Rhode Island, 100 jobs would disappear, $3.4 million in wages would be lost, and $1.8 million in federal, state, and local taxes would go uncollected, if 35 percent of our annual Housing Credit production were lost.

Mr. Chairman, Congress had the right idea when it created the Housing Credit. It is the most successful federal affordable housing program ever. Protect it now from the unintended negative consequences of the dividend exclusion proposal.

Thank you for your attention. NCSHA is available to assist you in any way.



Sprague Senior Housing - Spokane, Washington

Units: 25
Serves: Senior Citizens

Sponsor: National Church Residences and Whitewater Creek, Inc.

Uphams Corner Market - Boston, Massachusetts

Units: 45
Serves: Families and Elderly

Sponsor: National Historic Register by New Communities Services, Inc.

Chairman THOMAS. Thank you, Mr. Godfrey. That was not a tape you brought with the sounds of construction in the background. That is the sound of safety, because they are remodeling some offices for the homeland security office; and it was just a very appropriate backdrop while you were talking about housing construction.

Mr. Salisbury, thank you for your testimony. Obviously, when you change the relationship between stocks or preferred stocks with dividends and annuities, people who thought tomorrow was going to look like today are trying to reassess it.

In the testimony from the Secretary of the Treasury, there was indication that talks were being carried out, and there was a possibility for a technical amendment that might adjust the concern that I think all of us share, that what is now a working, viable employee-employer relationship in being able to think about annuities and pensions in one particular way that benefits employees more so than in the past.

Can you give me a flavor of the kind of discussion you would hope would be carried out in terms of the, quote, unquote, technicalities? Do you see an ability to narrowly and specifically resolve this differences between the two, short of some of the more fundamental approaches that Mr. Shackelford outlined?

Mr. SALISBURY. It would essentially, Mr. Chairman, be the same type of adjustment that the Secretary mentioned vis-a-vis annuities, that essentially within any defined contribution account, whether it be an IRA or a 401(k), a money purchase plan, you name it, that essentially you would keep track of the amount of money that was attributable to dividend and these other features and that would not be treated as taxable income at the time that the money comes out.

I will then quickly add, and I think this is true for annuities as well as qualified plans, keeping track of that would add a level of complexity to plan Administration that—well, I wouldn't want to have to deal with personally.

Chairman THOMAS. Well, my question was going to be, that is easy to say, how easy is it to do, and you answered it, and then obviously complications related with that. Thank you.

Mr. Shackelford, I think you outlined some alternatives, obviously, put them both on or take them both off; and I think you also correctly focused on I believe one of the reasons people perhaps don't look at the corporate side solution. One, it deals with the assumption that you are reducing tax on corporations, which is kind of a symbol. The other one, of course, is the revenue estimate is considerably higher. Either one would be I think appropriate alternatives to produce results similar to the way they want.

Then you said there were other tweaks, and you didn't go into the specifics of the tweaking. What did you mean by that?

Mr. SHACKELFORD. I was really referring that if you do anything and change the status of dividends, the ripple effect goes throughout the Code. I would have given an example——

Chairman THOMAS. I assume that is good or bad?

Mr. SHACKELFORD. Good or bad, that is exactly right.

I will give you an example. Currently, we—if a company has excess compensation for, say, its chief executive officer, there are

rules that would reclassify that excess compensation as a dividend. So, in some sense, that is a safeguard against maybe a closely-held company paying out an excessive amount of wages to its owner, the backstop being the dividend.

If you alter the dividend taxation, you alter backstops such as that. Now, those backstops, if you will, have come about because we have had a classical system with the dividend tax penalty for decades. You alter any part of that dividend tax penalty—and I would argue that there are some very positive efficiencies to doing that, but it will ripple throughout the Code. That was what I meant by tweaking.

Chairman THOMAS. Well, the discussion has been among some panelists and among Members that some of the positive aspects of the reduction of dividend is obviously a drive toward single tax structure, which would move the United States immediately from one of the most taxed in the area to no other country status as a single or integrated tax structure, but that the positives of corporate behavior and other changes, some have argued that if you stop anywhere between today and completely eliminating the double taxation, you wouldn't get any of the benefits.

It sounds to me like when you say even if you tweak there are ripple effects, are you saying that if you found some position between today's current double taxation and the removal of a complete side of that double taxation, that some halfway house would also produce more or less halfway benefits of some sort?

Mr. SHACKELFORD. Yeah, I think that is entirely possible. I would caution against complexity provisions such as the President's bill has. I believe that, in an attempt to do good, you can cause a great deal of problems by adding the complexity that we see in the current proposal.

Chairman THOMAS. So perhaps in looking at if someone was interested in alternatives in terms of bang for the buck, the degree of taxation is equal to, less than, greater than the added complexity. Or is the usual tradeoff in terms of you would like to get the tax down, but if you add complexity it may not be worth it; if you can simplify, you don't have to go so far down on the tax; the usual kinds of tradeoffs?

Mr. SHACKELFORD. The usual types of tradeoffs, yes.

Chairman THOMAS. Mr. Godfrey, I understand your concern about the President's proposal; and, obviously, Mr. Shackelford has looked at some alternatives. Have your folks looked at alternatives, short of simply saying, don't do what the President has asked for, so that you could get some of the positive aspects of removing the double taxation but not the downsides that you are concerned about?

Mr. GODFREY. Yes, sir. We have looked at several alternatives. We believe the most straightforward one is to treat Housing Credits in the same manner as taxes paid, so that the same benefits would be passed through to the shareholders. This is how the foreign tax credit is treated, and we believe that treating the Housing Credit in the same way is the best way to alleviate the effect.

Chairman THOMAS. My only reaction is the reasoned articles about an old tree growing near the road and they need to expand the road, and one of the suggestions is why don't you just pave

both sides of the tree. You have still got the tree, but you can get around it.

From your perspective, I think that does solve the problem, but I think the complexity and the difficulties and the others associated with the people who are going to form outside Charlie Rangel's door to have another lane added to the highway going around the tree, because all they need to do is to be treated in an equal manner.

Perhaps a more fundamental examination of the proposal could address your problem as well, rather than the straight suggestion that you offered.

I want to thank all of you for your testimony. All of us are concerned in simplifying the Code. Most of us I think—well, I would say all of us are concerned in reasonable and appropriate reduction of taxes, but, given the President's proposal, which I think is bold and innovative, the reason for the extraordinary number of hearings is to make sure that as we move forward, we have as great an understanding of what happens behind the various tax provisions as the tax provisions themselves, and I want to thank you for your testimony.

Does the gentleman from New York wish to inquire?

Mr. RANGEL. Thank you, Mr. Chairman; and let me thank the panelists.

Mr. Godfrey, I personally believe that the solution to this problem would be a commitment by the Federal Government to provide affordable housing as well as health care to all of its citizens. Clearly, when we have to go to the Tax Code to provide incentives, it means that the government has failed to see it as their responsibility.

Having said that, since it is the only thing we have had to provide affordable housing, it would seem to me that the government has an obligation to show what they would do to at least allow people to make investments that would help us to provide the housing that is necessary for our Nation.

When we find this Earth-shaking proposal by the President, it would seem to me that this could put a chill in operations, not knowing what the future would hold in terms of tax benefits if this becomes law. We don't know where this proposal is going to go, but do you have any recommendations as to what the Congress can do to give some assurances that, if indeed this becomes law, that we are aware of the problem and that we will be searching for some type of solution to this problem so that we can remove the damper on investments into low-income housing?

Mr. GODFREY. I agree with you a hundred percent. It would be more straightforward to solve the housing issue, you know, in a more straightforward way than through the Tax Code, but that is the chosen vehicle, and it is a way in which the private sector is engaged, and it really is the only way.

Affordable housing is a noneconomic activity. If we are going to bring the private sector in, then the Tax Code is the way to do it. It has been done that way—well, I have been working this for 3 decades, and it has been done that way.

We also know that uncertainty is the enemy of these kinds of investments. When year after year we had to come back for exten-

sions of the Housing Credit program before it was made permanent, the price that was received was much less because corporations faced that uncertainty. Once it was made permanent, the efficiency of the program soared upward. Unfortunately, we are seeing right now, because of the introduction of this proposal, that uncertainty has returned. Prices are already softening and, unfortunately——

Mr. RANGEL. If the gentleman would yield, I would notice that we have changed physically the Chair of the Committee, which gives me the opportunity—you think it would help if the Ranking Member and the Chairman of this Committee agree that we are going to resolve this problem some kind of way, that might give some assurances to investors in the low-income housing area?

Mr. GODFREY. Absolutely, sir.

Mr. RANGEL. Well, I think we can get assurances from the Chair that we intend to rectify that. This was an unintended thing that we have in the President's proposal, but we as the taxwriting Committee would make certain that we hold investors harmless in this area. What do you say, Mr. Chairman?

Mr. SHAW [Presiding.] I say, don't go there.

Mr. RANGEL. Well, I do hope that Mrs. Johnson will be able to persuade you that is the right thing to do.

We do recognize the serious nature of the problem. As you pointed out, we have handled this in a bipartisan way over the years with the overwhelming majority of the Members, and I cannot see where stubbornness is going to prevail over common sense and reason.

I want to thank you for bringing this eloquently to the attention of this Committee.

Mr. GODFREY. Thank you, Mr. Rangel.

Mr. SHAW. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

First of all, I would like to address the comparison to the foreign tax credit. That is really not a good analogy. The foreign tax credit, as you may know, is designed to prevent a corporation from paying taxes in two different countries on the same income, whereas the low-income Housing Credit is a true tax credit. It gives you a credit for some worthwhile expenditure or investment that we deem through the Tax Code. So it is not really a good comparison, and I don't think you should use that.

Many of us on this Committee have been supporters of a low-income Housing Credit. As you pointed out, it has become a permanent fixture in the Tax Code. It has given some security to those corporations who want to make that decision to get that benefit. They know it is going to be there, and that has helped increase the low-income housing—the use of the low-income Housing Credit, and I support that.

However, we also do a lot of other things through the Tax Code and through appropriations to encourage people to provide low-income housing, whether it is the HOPE program, the HOME program, programs to encourage home ownership for low-income people. We do a lot to try to help folks get homes, either through renting or purchasing; and I would hope that this Committee would look at the benefit—the overall benefits of the President's proposal,

whether we do it exactly as he has suggested or as Mr. Shackelford has suggested or others for alternatives and look at the benefits to the entire country, even to the low-income housing opportunities in this country, rather than focusing on one tax credit that may or may not be substantially harmed.

Mr. Godfrey, I am told that there are elements of the low-income housing industry that disagree with the study that your association commissioned. For example, the National Association of Home Builders does not agree with the estimates provided by Ernst & Young. Are you aware of that disagreement within the industry; and, if so, do you have any explanation for those disagreements?

Mr. GODFREY. Yes. First of all, I apologize if you thought I was comparing the Housing Credit to the foreign credit—I wasn't. I am just saying you could treat the Housing Credit as you have treated the foreign credit. They obviously are very different, so I am sorry.

Yes, and certainly we understand—we have heard—we have not seen any reports at this point in time, but certainly the Home Builders and some of the other industry associations disagree with Ernest & Young, but their primary business is not affordable housing. They have many other interests which they push, and the affordable housing issue is just a very small part of their business. This is our only business, and it is a business—this doesn't serve the Housing Credit. It serves low-income people. In fact, we put a lot of soft money into these programs, and that is the issue that Ernst & Young specifically addresses, the lower price that investors will pay for these credits will require an increase in soft money.

We ran that test in Rhode Island and applied it to the developments which we did over the past 3 years. We found the impact would have been 32 percent fewer units, which is really very close and statistically identical to the Ernst & Young report.

So we have studied that proposal very carefully. I know Ernst & Young went at it absolutely independently. Their tax partners vetted it thoroughly. I have Mr. Fred Copeman here, who is a tax partner at Ernst & Young, who participated in this report.

Many of us in the housing field thought the impact would in fact be greater. We knew they excluded certain items that would make the scenarios much worse. So, having vetted it ourselves—I know it went through a number of vettings within Ernst & Young and testing it in Rhode Island. I feel the number is pretty good.

Mr. MCCRERY. Thank you. Mr. Shackelford—well, my time is up.

Mr. SHAW. We have now been joined with Mr. John Makin, who is Resident Scholar, Fiscal Policy Studies, American Enterprise Institute. I understand your plane was late, so we appreciate the extra effort to get here.

If you would like, just for a couple moments, to summarize your statement into the record, then we will continue the questioning.

Mr. MAKIN. Thank you.

Mr. SHAW. Turn your microphone on, please, sir.

STATEMENT OF JOHN H. MAKIN, RESIDENT SCHOLAR AND DIRECTOR, FISCAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Mr. MAKIN. Thank you very much Mr Chairman and Members of the Committee. My apologies to the Committee and the other witnesses for being late. I left on the 7:30 shuttle, but Delta had other plans.

I would like to offer a few comments in support of the President's proposal to eliminate the double taxation of dividends.

I do think it is sound policy; and I recognize that, like all steps toward a better balanced tax system, it will be resisted by those who have adapted to the distortions in the current Tax Code. Some will claim it is not stimulative, an incorrect assertion; while others will claim that fewer are affected by tax provisions on dividends. Still others will claim that it will raise the deficit and raise interest rates and thereby be counterproductive. I would like to address these issues.

First, what about problems with current policy? The current double taxation of dividends has produced three types of behavior that penalize growth. It encourages over-reliance on debt finance. That requires firms to meet rigid debt service payments, whereas equity finance enables firms to pay a flexible stream of dividends and makes it easier to deal with the business cycle.

Second, double taxation of dividends encourages management to retain cash inside the corporation rather than pay it out. We have seen that companies have a tendency to over-retain cash. I am surprised that so few commentators on the dividend taxation proposal have noted the connection between corporate scandals and the high level of cash retention in what were the fastest-growing companies during the stock market boom. High levels of cash retention inside the company led to a temptation not only to invest too much in a given area but to make loans to corporate insiders on overly generous terms. The rationale for such insider largesse is usually the idea that if the head of the corporation were forced to sell stocks, it would depress stock prices.

Some in Congress have criticized the President's proposal to end the double taxation of dividends because they say that few of their constituents receive dividends. Here, again, the adaptation to current distortions in the Tax Code are important. Double taxation has indeed reduced dividend payouts, and fewer people are receiving dividends. The ratio of dividends as a percentage of earnings has fallen from about 60 percent in 1995 to about 40 percent in 2001. An end to the double taxation of dividends would mean more dividend payouts, thereby increasing the constituency for the better tax treatment of corporations.

Higher after-tax returns for investors receiving dividends would increase the price they would pay for stocks of companies paying dividends. In those companies, the cost of capital would fall, they would invest more, add to the capital of stock, increase the productivity of workers and pay higher wages to the workers. The overall stock of capital would increase, while the composition of the capital stock would be improved by virtue of the removal of the distortion that creates too much capital of companies that rely heavily on debt.

Any measure that reduces taxation results in the short run, at least, in a lower level of government revenue. By undertaking tax reform measures such as the elimination of the double taxation of dividends, the Federal Government is, in effect, utilizing its borrowing power to invest in a better functioning economy by reducing distortions and burdens created by the tax system. Based on static revenue measures, elimination of the double taxation of dividends calls for the Federal Government to borrow about $300 billion over 10 years in order to finance a measure that reduces distortions, increases stock prices and results in a higher capital stock and higher real wages.

As such, the net cost of the measure will be considerably less than the initial estimate of revenue lost. Indeed, over a long-time horizon, investment in measures to reduce distortions in the tax system ought to be self-financing.

In conclusion, elimination of the double taxation of dividends constitutes low-hanging fruit in the tax reform area. It would be an excellent start down the road to full elimination of the tax on corporate income and a movement toward an integrated tax system where corporate income is imputed to owners—households—and taxed once at that level at the same rate that all income is taxed. That would be real tax reform. It is time to return to this important agenda begun in 1986 with the support of many Members—in both parties—of this distinguished Committee. Thank you.

[The prepared statement of Mr. Makin follows:]

Statement of John H. Makin, Resident Scholar and Director, Fiscal Policy Studies, American Enterprise Institute

Mr. Chairman and Members of the Ways and Means Committee, Thank you for the opportunity to testify on the President's proposal to eliminate the double taxation of corporate dividends.

The proposal is sound tax policy. Let me say what the proposal will and will not do. Like all steps toward a better-balanced tax system, it will be resisted by those who have adapted to the distortions in the current tax code. Some will claim that it is not stimulative (an incorrect assertion) while others will claim that few are affected by tax provisions on dividends. Still others will claim that it will raise the deficit and raise interest rates and thereby be counterproductive. I would like to address all of these issues and suggest the positive reasons why eliminating the double taxation of dividends is an excellent investment for the Federal Government to undertake.

Problems with Current Policy

The current double taxation of dividends has produced three types of behavior that penalize growth. First, double taxation encourages overreliance on debt finance by corporations. Debt finance requires firms to meet rigid debt service payments, whereas equity finance enables firms to pay a flexible stream of dividends, thereby making it easier to deal with unstable cash flows during business cycles.

Second, the double taxation of dividends encourages management to retain cash inside the corporation rather than pay it out. New technology companies that experience a surge in cash flow may not be, as we have seen, the best judges of the need to further expand capacity. Elimination of the double taxation of dividends puts pressure on management to pay out cash to investors and allows those investors to decide if they want to reinvest in that firm or invest elsewhere where prospective growth may be more promising.

On this second point I am surprised that so few commentators on the dividend taxation proposal have noted the connection between corporate scandals and the high level of cash retention in what were the fastest growing companies during the stock market boom. High levels of cash retained inside the company lead to the temptation not only to invest too much in a given area, but to make loans to corporate insiders on overly generous terms. The rationale for such insider largesse is usually the idea that if the head of the corporation were forced to sell stock, it would

depress the stock price and thereby impede the growth of the company. That line of thinking has led to disastrous consequences for some of the fastest growing companies of the late 1990s.

Some in Congress have criticized the President's proposal to end the double taxation of dividends because they say that few of their constituents receive dividends. This is like observing on a sunny day that few people are using umbrellas. Double taxation has indeed reduced dividend payouts and so fewer people are receiving dividends. The ratio of dividends as a percentage of earnings has fallen from about 60 percent in 1995 to about 40 percent in 2001. An end to the double taxation of dividends would mean more dividend payouts, thereby increasing the constituency for better tax treatment of corporations.

How Would Eliminating the Double Taxation of Dividends Increase Growth?

Higher after-tax returns for investors receiving dividends would increase the price they would pay for stocks of companies paying dividends. For those companies, the cost of capital would fall, they would invest more, add to the capital of stock, increase the productivity of their workers, and pay their workers higher wages. The overall stock of capital would increase while the composition of the capital stock would be improved by virtue of the removal of the distortion that generates too much capital of companies that rely heavily on debt.

Once again, the experience of the last several years is testimony to the advisability of reducing overreliance on debt while simultaneously encouraging companies to pay out earnings to investors. The increased pressure to pay out earnings results in a higher hurdle rate for investment with retained cash and thereby helps to avoid the excessive buildup of capacity in industries that may be experiencing a period of rapid growth the benefits of which ought promptly to be shared with owners of the companies' stock rather than husbanded inside the company.

The desirability of eliminating the double taxation of dividends is hardly a novel concept. It is advocated in nearly every textbook on public finance and practiced, at least partially, in most major industrial countries. Indeed, the maximum effective tax rates on dividends are higher in the United States than in any of the G7 countries.

Larger Budget Deficits?

Any measure that reduces taxation results in the short run, at least, in a lower level of government revenue. By undertaking tax reform measures such as the elimination of the double taxation of dividends, the Federal Government is, in effect, utilizing its borrowing power to invest in a better functioning economy by reducing distortions and burdens created by the tax system. Based on static revenue measures, elimination of the double taxation on dividends calls for the Federal Government to borrow about $300 billion over ten years in order to finance a measure that reduces distortions, increases stock prices, and results in a higher capital stock and higher real wages. As such, the net cost of the measure will be considerably less than the initial estimate of revenue lost. Indeed, over a long time horizon, investment in measures to reduce distortions in the tax system ought to be self-financing.

That said, there is no denying an additional supply of government securities, say over the first five years of the program, which are estimated to be $132 billion. The addition of $132 billion over five years to a pool of debt including government, corporate, municipal, and mortgage debt in the United States totaling about $18 trillion currently is hardly likely to produce an impact on interest rates. Indeed, in the current environment of excess capacity in some industries, one might hope that tax measures could be found that would result in higher interest rates, not through crowding out but, rather, by generating higher real returns on capital. Such higher real returns would require higher real interest rates on other investments such as U.S. government bonds to compete with the enhanced attractiveness of investments in new industries.

Conclusion

Elimination of the double taxation of dividends constitutes low-hanging fruit in the tax reform area. It would be an excellent start down the road to full elimination of the tax on corporate income and a movement toward an integrated tax system where corporate income is imputed to its ultimate owners—households—and taxed once at that level at the same rate that all income is taxed. That would be real tax reform. It is time we return to that important agenda, begun in 1986 with the support of many members—in both parties—of this distinguished committee.

Mr. SHAW. Thank you, Mr. Makin. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman. I would like to pose to all of the panelists the following question: The dividend component of this package is the key driver of long-term economic growth; and, as it has been mentioned, it levels the playing field in the Tax Code so as to lessen the bias against savings, reduce incentives to take on more debt and excessively retain earnings. Due to the current bias in the Tax Code, companies in some cases mass much larger piles of money than they need to. For any or all of you, can you explain the economic impact of this problem and can you elaborate on how the growth plan before us encourages savings, therefore increases the wealth of all Americans?

Mr. MAKIN. I could take a shot at that. I think that is an important issue.

You know, corporate managements have not been, I would say, overly supportive of this proposal in some cases, and I think one of the reasons is that they are tempted to retain too much cash inside the corporation. I will give you an example.

Porsche makes wonderful sports cars. It is a closely managed company that has a tremendous amount of cash on hand. Now what they decided to do with the cash was build a sport utility vehicle (SUV), at a time when SUVs are probably not going to be in great demand. Maybe this will turn out. Maybe it won't. My point is that if you force corporations to pay out cash, then they have to confront the choice that investors might make for use of the cash. An investor might want to decide whether to expand capacity of a given company or invest the money elsewhere. That is how you improve resource allocation, by giving companies an incentive to pay out dividends, instead of saying, oh, we don't want to pay out the dividend; it would be bad for the stock price. We will retain it, and you will get it back in capital gains. That story came to a very sad end in March of 2000 when the stock market started to drop.

Mr. ENGLISH. Any other comments? Mr. Shackelford?

Mr. SHACKELFORD. I concur with much of what you were saying.

I would say that, because companies will have the option to adjust the tax bases in shareholders' stock, it is not necessarily clear to me that there will be a surge in dividends. In other words, companies can retain the money, and they can say to their shareholders, your capital gains tax bill will be less. So I am not sure that we would see that many more companies paying that much more in taxes, and that is—I mean, I am sorry, that much more in dividends, and that is the trigger device that needs to be done here.

Furthermore, because the dividends are only tax exempt if the companies—you know, it goes through this complex calculation, but the company is paying taxes itself. Many companies, because of the recession and also companies because of large stock option deductions, aren't paying that much taxes themselves. So I am not sure if the jump-start is in the proposal the President has.

Mr. ENGLISH. Let me tackle a different question, one that I posed to the Treasury Secretary the other day.

By stepping up the basis when a corporation does retain its earnings, the proposal effectively cuts the capital gains tax rate. The re-

sult is an equalization in the treatments of the two ways corporations return their investment to shareholders, and from the Treasury Secretary's response this is obviously something that was in the front of their mind in designing this provision. My question is, how significantly does this impact the cost of capital in the short and the long term? Mr. Makin.

Mr. MAKIN. Well, I think it is important to distinguish between the ultimate position once you change the law governing dividend distributions and the initial position. Clearly, the impact on capital gains is important, but as time goes by and more companies elect to pay dividends, as I think they will given that—the attractiveness and the possibility of reducing the cost of capital. The issue on capital gains that the Treasury is concerned about will become less pronounced. Ultimately, it won't be as important, because capital gains won't be as important a part of the picture affecting the tax burden on companies. We will get a lower cost of capital without double taxation of dividends. The problems associated with the treatment of capital gains that will be complicated in the transition will gradually atrophy.

Mr. ENGLISH. Thank you very much for your testimony.

Mr. SHAW. Mr. Levin.

Mr. LEVIN. Thank you very much, and a hearty welcome.

This panel has been I think, perhaps more than the previous ones, marked by shades of gray instead of making these issues black and white, and I think it is helpful to understand the problems as well as the—whatever are the alleged potentialities. I think, Mr. Salisbury, your testimony should be read by everybody and the issues raised I think understood by everybody.

Let me just ask Professor Shackelford, you come up with an equal treatment provision or proposal. There is opposition to it because of its cost. Mr. Thomas, the Chairman, spelled out a couple of the problems. I think there is also opposition beyond that, isn't there? This idea has been floated for some time, your idea in terms of allowing a deduction within the corporation, right? There has been resistance from good parts of the corporate community, I think. So talk about that, if you would.

Mr. SHACKELFORD. I hesitate to speak for the entire business community, but let me say that I think that one of the problems which I think has been alluded to here before is that corporate management does not want to have pressure put upon them to distribute out their cash reserves. So if there was the full deductibility of dividends, shareholders would be in a very strong position to say to management, you have extra cash; give us that money. If we think your future investments are good, we will be glad to give you the money back. You could have a dividend reinvestment type policy.

I could certainly understand if you were to see a company—particularly if you have some goals you would like to achieve over some long period of time, you would like to keep a cushion of cash with you.

So, as the other witness mentioned, I don't think the business community would be—large corporations, I don't think many of those companies would be strongly behind having dividend deduct-

ibility, simply because it would take away the shield that they currently have with double taxation.

Mr. LEVIN. From a sound economic point of view, though, how sound is that objection? I mean, I understand whatever you want to call it, the self-interest—maybe that is too strong a term—but in terms of sound economic policy, since your approach, whatever the cost in a sense is simpler, how legitimate from an economics point of view is that complaint? It doesn't force the granting of dividends, right?

Mr. SHACKELFORD. That is exactly right.

Mr. LEVIN. So tell me—forget for a moment the interplay and all that. From an economics point of view—you are a professor of economics.

Mr. SHACKELFORD. Well, I am actually professor of accounting.

Mr. LEVIN. Accounting. That is part of economics.

Mr. SHACKELFORD. I do know economists.

Mr. LEVIN. I had as much trouble with accounting as I did with economics.

Mr. SHACKELFORD. I believe we would be best off if money is in its best and highest use. So if we have two companies that are identical, one has very bright prospects, they have excellent plans, people want to be involved with that company, I don't think they are going to drain the cash out of that company. They will say, my money is better with that company than in my pocket. However, if we have another company that has cash but they don't have a tremendous amount of prospects, we are better off to take the cash out of that company, give it to the shareholders, let the shareholders redistribute that money to other places in the economy where it can be better used.

So I would think that this provision would be of great interest to those who want to see capital flowing to start-ups, to entrepreneurs, to companies that have great prospects but right now have difficulties accessing the capital markets because some of the capital is tied up. The tax system is partly responsible for this. Capital is tied up in companies where there is a cost to getting the money out.

Mr. LEVIN. Mr. Godfrey, that doesn't solve your problem, though, does it?

Mr. GODFREY. No, it does not.

Mr. LEVIN. So how do we solve, I think, the very legitimate issue you raised with this simpler idea? I am not saying bad or good, but it is simpler, I think.

Mr. GODFREY. The goal—and I have heard this many times—is to change corporate behavior. To the extent you change corporate behavior with the Tax Code, it has a lot of ripple effects, and the Housing Credit is going to suffer. I know that—I have been talking to investors over the years, and their sole reason for investing in these is the tax benefits and the financial issues. So to the extent that you take those away, they are going to leave the market.

Mr. LEVIN. Thank you.

Mr. SHAW. The time of the gentleman is expired. I would point out to the gentleman, as a former certified public accountant myself, we deal with facts, not theory, as the economists do.

Mr. LEVIN. Well, I think Professor Shackelford was saying what the facts are——

Mr. SHAW. Mr. Weller.

Mr. LEVIN. As an accounting expert.

Mr. WELLER. Thank you, Mr. Chairman; and I also want to thank the gentlemen on the panel today for participating in today's hearing, obviously a very important issue for us.

I think we all agree we need to get this economy moving again. The district that I represent in the south suburbs, we have employment as high as 9 percent in LaSalle County, so it is of great concern to the folks I represent.

They appreciate the leadership the President is showing on his economic growth package. They like the fact that he is making the rate reductions effective immediately. They like the fact he is eliminating the marriage tax penalty immediately, rather than phasing it in. They like the fact that he is doubling the child tax credit immediately; the fact that they will see immediate relief and have extra spending money, in fact, higher tax-home pay as a result of the President's proposal, an extra $1,068 per Illinois taxpayer in higher take home pay. They like that, because they recognize when consumers will have extra spending money that money will be spent in the local economy. So there is broad support for that.

The area that I represent of course has a large number of small manufacturers. Usually family-held businesses are the big employer in town. Usually, it is the side of town where they have maybe, you know, two, three hundred employees that have been there for several generations. They are competing with our foreign competitors today.

I guess, you know, they look at the President's proposal, and obviously they see the benefit to their employees, the workers, but they are wondering about the impact of the dividend proposal as it will affect them directly. They are not publicly traded. They are family held. They are family businesses. I was wondering, Mr. Makin, could you comment on that? How would we explain how the President's dividend proposal would benefit those small manufacturers?

Mr. MAKIN. I do think there is an important way, and other panelists have alluded to it. That is, if you encourage investors to ask themselves would I rather—allocate funds elsewhere even though a company has done very well, and the earnings have gone up.

If the tax system makes it necessary or more necessary for companies to face a demand for higher dividend payments when their incomes rise, then investors are going to be more free to reallocate the returns from investing in a large company. So induce companies to pay out higher dividends by making those dividends tax free to investors.

Mr. WELLER. How does that directly benefit?

Mr. MAKIN. Investors then have more investable funds and they may wish to invest in smaller companies.

Mr. WELLER. In case a company is going to sell out, is what you are saying, not the family-held business?

Mr. MAKIN. If it is a family-owned business and it is not accessing capital markets to finance an expansion and its activity, then

this isn't going to have a direct effect. If, however, it was looking for startup money, it would have an effect.

Mr. WELLER. Thank you, Mr. Makin. When I talk and listen to the managers and those that operate the small manufacturers, which really are the backbone of the economy in the area that I represent, they suggest we need to do more in the area of accelerated depreciation. They like the idea of expensing because they feel it encourages great investment, new company cars and delivery vehicles, telecommunications equipment, replace the office computer. They see that as creating jobs and driving investment, particularly in smaller, lower companies.

Mr. Shackelford, I see you are a tax expert at the university level and I am just wondering, you have looked at the President's proposal when it comes to the expensing provision, which is targeted to small businesses, the 179. Do you have any thoughts about that? Could you see changes we can make in that proposal to benefit more small manufacturers and support them as well?

Mr. SHACKELFORD. I would expect they would like that. I mean that is a movement toward a consumption tax to have immediate expensing of capital equipment et cetera. I think that the dividend proposal probably won't have much effect on those companies because they are likely to be structured as an S corporation. So they are not in the double taxation C corporate world. I think you would be correct in assessing that something like additional expensing would be something they would be more interested in.

Mr. WELLER. I realize my time is running out. Do you have some suggestions as to how we can expand the President's proposal on expensing to benefit the smaller manufacturers, particularly those family-held businesses?

No? Okay. Mr. Makin, any thoughts?

Mr. MAKIN. As I understand it, and I may be wrong that the President's proposal already does expand expensing provisions. I have seen him criticized for it. There is a front-page article in the USA Today that a business could buy a SUV and not pay tax on it.

Mr. WELLER. It is targeted of course, those who qualify under the Tax Code, the definition of small business. Many of these small manufacturers do not qualify.

Mr. SHAW. The time of the gentleman has expired. Mr. Ryan.

Mr. RYAN. Thank you, Mr. Chairman. I want to ask you, Mr. Shackelford, a couple of questions about the complexity issue. You described the legislation that I introduced which was total deductibility at the corporate level, and in my bill I bring the dividends tax rate down to the capital gains tax rate, so there is no difference in the tax rates. There are two issues that seem to be at play here that I think we are all digging into. One is a competitiveness issue. If you take a look at the chart over here, it is tough to read. It is the dividends one. If you combine the dividends tax rate, the corporate and the personal tax rate, we tax dividends higher than any other industrialized Nation in the world save for Japan. So our competitiveness on a global basis is extremely important here, and we are very uncompetitive.

The second point is, and I think a number of you mentioned and, Mr. Makin, you did as well, the ultimate goal in tax reform ought

to be to tax income once at its source and never again, correct? Would most of you agree that is a good, achievable goal to get toward simplicity and toward economic efficiencies—the complexity? The bill that I introduced that you described is very simple, very easy, no calculations are really needed, no basis adjustment. Looking at the Administration's proposal, the cost from a revenue law standpoint on an aesthetic basis is about a third as much. So you mentioned that as well. One thing that the Administration proposal gets you is you don't double tax on capital gains as well because of the basis adjustment. So the approach that I have been taking does stop double taxation on dividends, but doesn't stop double taxation on capital gains. The Administration's proposal, which costs a third less than my bill, does effectively stop double taxation not only on dividends but on capital gains as well. So, you do get more bang for your buck.

What I want to ask is how complex do you think it is to calculate the EDA, the excludable dividend amount? Do you believe that the Tax Code today does not have an accurate measuring stick to track a dollar as it moves through the economy through corporations to ensure that that dollar is never again taxed again? Is not the EDA necessary to put this new computation into the Code so we can track that dollar through the economy to assure that it is never taxed again?

Mr. SHACKELFORD. Well, I think if you go to a plan like what the President has you have to have something like EDA, and certainly it is calculable. A company will issue a 1099. It will have on there total dividends paid, basis adjustment, total dividends, they are taxable, et cetera. I think that the more difficult issue is trying to tax plan in such a world. So—trying to tax plan in that world. I own a stock and I get a dividend in March, I won't know if that dividend is fully taxable or not or how it will play out. I sell my stock. It is very difficult to plan under that situation.

Mr. RYAN. If you allow the firms to calculate when they pay out their dividends and how to structure their REBA, their retained earnings basis adjustment, then don't you get out of that problem because it goes into their cumulative retained earnings basis adjustment? So if the firm gets to elect when they distribute, when they notify, that problem is kind of solved, isn't it?

Mr. SHACKELFORD. We adjust basis this year because we had more income than we had paid out taxes. A year from now we decided no, we will pay out dividends and adjust the basis back down.

Mr. RYAN. That comes out of the cumulative, not the annual.

Mr. SHACKELFORD. These are the kind of cross-year issues that gets things very, very complicated, and I think there is a real cost complication because I think the American people don't understand why things are complicated and begin to lose trust in the system.

Mr. RYAN. You think this complication outweighs the economic benefits that are achieved by not taxing that income ever again.

Mr. SHACKELFORD. I am afraid so.

Mr. RYAN. Mr. Makin, what is your take on that? You are sort of singing off the same song sheet.

Mr. MAKIN. I am an economist and not an accountant and I think I will defer to an accountant on this. I would say there is no

provision in the Tax Code that the well paid industry that advises us to deal with it could not manage. So certainly they have plenty of challenges and I am sure they could rise to this one.

Mr. RYAN. It seems to me the EDA is fairly easy to compute. It is on the Schedule J. Mr. Godfrey's points, which are well taken, aside, I think the calculation is fairly easy. Have you, Mr. Salisbury and Mr. Godfrey, looked at the complexity issues? I understand that you think, Mr. Godfrey, if you just add your low income housing tax credit back into the EDA, problem solved, correct?

Mr. GODFREY. Some of it is, yes.

Mr. RYAN. Mr. Salisbury, what is your opinion?

Mr. SALISBURY. I think the problem, and to use the words you were using, of elimination of double taxation of dividends is that one of the problems related to close to 35 percent of all publicly traded equities is they are currently owned by pension plans, and all of those dividends will still be subject to double taxation. The bigger problem with that is that far more individuals own securities, if you will, through qualified plans at low and moderate income levels than through the general stock market. So essentially what we are doing through these proposals, without figuring out how to deal with qualified retirement plans, is we are basically saying for low and moderate income individuals they will still pay double taxes on dividends. In fact they will pay it at maximum marginal tax rates that they have and that they face, while those lucky enough to have real assets in the economy and are not dependent on qualified plans will not pay those taxes.

Mr. RYAN. Notwithstanding the value in all equities that occur because of the proposal. I see my time has expired.

Mr. SHAW. The time of the gentleman has expired. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. Let me join with my colleagues to say how much I thought this panel was very helpful in our deliberations and has really raised some issues that we need to take up.

Mr. Salisbury, I want to continue the discussion you had with Mr. Ryan. I would encourage my colleagues to read this testimony, because an interesting observation or interesting facts have taken place over the last 10 years, and as you point out there has been a significant increase in a number of retirement plans, qualified plans that are being offered by smaller companies. That is good news, and I think that this Committee should take some pride in the legislations that we have supported and enacted as having an impact in creating more opportunities for employees at small firms to participate in employer-sponsored pension plans.

I am glad Mr. Portman is here because his leadership has been instrumental in that regard. Both of us believe and I think this Committee believes that it is important particularly for younger workers and lower wage workers to have some additional incentive other than just the Tax Code in order to participate in the pension plan, and that is why these employer-sponsored plans are so important and that is why small companies, particularly which haven't been major players in qualified plans, the increase here is very, very encouraging.

Mr. Salisbury, you made another observation. You indicated that in a few years if the dividend exclusion were enacted, it is your ob-

servations that it would become more attractive to go to the Roth IRA rather than to an employer-sponsored plan. I have serious concerns, because if that happens, whether lower wage workers and younger workers will indeed participate in retirement savings if there isn't an incentive offered up under an employer-sponsored plan. I would appreciate your comments on that because we spend a lot of effort to try to reverse the trend of the eighties where we saw a reduction in the number of pension plans with small companies. Now that we have it on the rise I think it would be tragic if the unintended consequences of this dividend exclusion was to reduce the number of employer-sponsored plans by small companies.

Mr. SALISBURY. I would add a statistic to go with what you are saying. In 2001, which is the most recent year for which IRS data is available, 2.7 percent of taxpayers made a contribution to an Individual Retirement Account. When an employer sponsors a program and encourages participation at the lowest income level, 75 percent of low income individuals and moderate income individuals take advantage of the payroll deduction opportunity most particularly and at higher rates if there is a matching contribution, which most of the existing plans will offer.

I would add the additional note is there is a Roth 401(k) feature that is in the law, but it is not to be effective until 2006. Were that accelerated, that would mitigate the need for the small employer to terminate the plan.

Mr. CARDIN. I very much appreciate that and I think, Mr. Chairman, this is something this Committee really needs to take a look at as we try to encourage more participation in retirement accounts.

Let me make one other observation with the panel on a different subject and that is, Mr. Makin, you mentioned there are distortions in the Tax Code. There are many distortions in the Tax Code. There are many inequities in the Tax Code. The double taxation of dividends is an inequity. We understand that. We have an AMT problem in the Tax Code that needs to be addressed. Many of us think that our Tax Code favors consumption over savings and that companies involved in exports are not treated fairly in our Tax Code. I guess my point is we are talking about a stimulus package here.

We do have, I think, some economists that are on the panel, but I have been told that the primary test for stimulus is how much money gets into the hands of the taxpayers, the consumers in 2003 that they can spend. The problem I find with the President's proposal is very little gets into the hands of the consumers in 2003, yet the cost of the proposal is rather—it is ongoing and will add to deficits. I guess that is one of our concerns. As we are looking for inequities to correct, it would be better, it would seem to me, if there was more bang for the buck in 2003. Any comments?

Mr. MAKIN. May I comment on that?

Mr. CARDIN. Sure. I have 30 seconds left. Don't take all 30 though.

Mr. MAKIN. Many Members of this Committee realize that there are many distortions in the Tax Code and I remember in 1985 and 1986 joining many of these Members of the Committee at study retreats to try to examine those distortions. Improving resource re-

allocation rises from changes in the Tax Code that remove distortions and improves the ability of the economy to grow. It is a supply side move. The quick stimulus you are calling for is demand side. I think you ought to do both.

Mr. CARDIN. My time has expired, so let me just comment, that is fine if we are looking at changes in the Tax Code generally. This is supposed to be a stimulus. This hearing is based on the President's stimulus package. Maybe we should be talking about the inequities in the corporate tax world as an issue that this Committee should take up, but I would argue it should be done in context with the budget and in context to the dollars that are available for tax cuts.

Mr. SHAW. The time of the gentleman has expired. I am going to allow one more Member to question the witnesses, and then we are going to have to recess for the vote that is on the floor. Mr. Houghton.

Mr. SHAW. Ms. Tubbs Jones?

Ms. TUBBS JONES. Thank you. We have been having this hearing for the past 3 or 4 days and I would like someone to talk to me about the dividend tax cuts. Let me start over. In the past 3 or 4 days we have been having these hearings on the dividend tax cut and the tax proposals, et cetera, and I have been anxiously awaiting someone who is going to talk to me about the impact it would have on low income housing credits.

I come to this Committee from the Committee on Financial Services. I come from the Subcommittee on Housing. I come from the City of Cleveland, where low income housing tax credits have brought our city back from names like "mistake on the lake" to a great place where we have had more housing starts and more housing being built in the City of Cleveland in the last 10 years than since the Korean War. I speak specifically about one particular place called Arbor Village, where we have rental housing for low income families where they can have low income housing with up to four bedrooms, and it is unheard of previously to have this opportunity.

So I am happy to have an opportunity to talk specifically about this issue, and let me say to Mr. Shackelford, Mr. Salisbury and Mr. Makin, I haven't heard you talk about housing credits. I am not going to ask you any questions. It is not that I don't like you or anything like that, but I want to give all of my time to Mr. Godfrey because I think the issue is so very, very important. It goes not only to what happens with regard to housing, but it goes to what happens to neighborhoods and building wealth in communities and building better communities and stronger families and having better schools. Mr. Godfrey, take up from there. It is your show.

Mr. GODFREY. I think you heard me say exactly the same things, and certainly Cleveland is an excellent example of using the tool and using community development corporations and revitalizing and turning cities around. I have seen it in my neighborhoods, and not only direct developments that are impacted, but surrounding properties and communities—when you bring investment in, it encourages the other landlords and the other home-

owners who have been there to bring investment in. All of the property values go up and it becomes a desirable place to live.

Ms. TUBBS JONES. The other thing of interest to me is that I am a lawyer by training and been practicing law in a courtroom and I understand the importance of long-term tax policy. The other reality is that long-term tax policy often can have a short-term deterrent impact on the ability of communities and people to build lives, and also they are in a pattern of what they are used to, not into a pattern of what could be in the future. Specifically, if we look at this low income housing tax credit that was created back in 1986 and then became permanent in 1993, that is when everybody kind of jumped on the band wagon because they understood the permanency of the tax credit to allow them to have some benefit over time.

Is that a fair statement, Mr. Godfrey?

Mr. GODFREY. That is an excellent statement. We have seen the efficiency and the productivity of the Housing Credit grow. I would certainly think if Congress is making a tax credit available, it would want to make sure we are getting the best bang for the buck and the bang that is increased every year. Unfortunately, under this proposal Housing Credits would cost the same amount, but would produce 40,000 fewer units.

Ms. TUBBS JONES. Mr. Chairman, I couldn't say it any better than that. I am yielding you back 2 minutes and leaving out of here. We got a new business Chairman. I yield back the balance of my time, Mrs. Johnson. Thank you very much. Mr. panelists, all of you, thank you so much for coming this morning.

Mrs. JOHNSON OF CONNECTICUT [Presiding.] I recognize Mr. Tanner.

Mr. TANNER. Thank you all for being here this morning. Should it be—I am going to try and change gears a little bit here and ask a macro question. Should it be a cause for concern in this country that 8 months ago we increased the national debt ceiling by $450 billion, which represented at that time about 8 percent of the debt of the country up to that time? We are going to breach that limit, according to the Secretary of the Treasury, sometime next month. Contrast that with the fact that we are now on a yearly basis on a $1.8 trillion revenue stream last year paying or accruing over $330 billion in interest, which translates to a 17 or 18 percent interest rate on our present income with regard to what has to be paid. Should that be a concern as we go forward talking about possible revenue loss as predicted by the Congressional Budget Office for the next foreseeable future, for the next 10 years? Should that be a concern we ought to address in this Committee?

Mr. MAKIN. I am supposed to be a macro economist, so let me take a shot at it. I think it depends. If the rise in the deficit was due to a surge in spending, perhaps on wasteful projects as we saw in Japan over the past decade, it would be a concern. If it is due to slower economic growth and tax cuts that are designed to revive growth, I don't think it should be a concern.

Many people suggest that the prospect of higher deficits would raise interest rates. This is what I often call the Rubin fallacy. I see absolutely no evidence that interest rates are rising and in fact

as we talk about larger deficits interest rates are falling because the economy does need the stimulus that the tax cuts offer.

Mr. TANNER. At what point, in your opinion, is there a point at which the carrying charges of the national debt, presently 17 or 18 percent, is there a point at which that will impede the ability of the government to make the necessary public infrastructure investments, whether it be in human capital in the form of education or in just bricks and mortar in terms of highways and airports and so on? Is there a point at which the public infrastructure investment ability is impeded because of interest payments being made on past debt that we aren't able to use that money for such things so that private enterprise can expand and grow?

Mr. MAKIN. Of course there is a point, but I think we are a long way from it.

Mr. TANNER. What would be your opinion?

Mr. MAKIN. Well, in Wednesday's Wall Street Journal, Martin Feldstein, who is no stranger to these issues, has suggested that if we undertook the tax cuts proposed by the President and under some conservative assumptions, we might see the ratio of national debt to GDP reach 35 percent, which is well within the safety zone. In the 1980s, the debt to GDP ratio got over 50 percent. In the 1980s we saw high growth. So we have been a long way away from a setting in which the Federal Government is borrowing at a level that would substantially crowd out private capital.

Mr. TANNER. Do any of the gentlemen have a comment?

Mr. SALISBURY. I would comment that the Committee should be very concerned about that issue, most particularly given the long-term liabilities related to Social Security, Medicare, the current funding problems on Medicaid, considering all of those factors.

Mr. TANNER. I am just a country lawyer, but I know that we can't borrow ourselves rich without breaking our children. Then what I hear from some of these economists is let us just continue to borrow, it doesn't matter what deficits are. I have never known any country that was broke and unable to provide the infrastructure for private enterprise to expand and flourish. If you think you can, go somewhere where there is no government and see how many people are rich. Very few.

I am sorry. Go ahead.

Mrs. JOHNSON OF CONNECTICUT. We only have 5 minutes before the vote and they don't hold it open any more, so I am not going to be asking questions. I did want to ask one question because the low income housing tax credit, while my colleague from New York suggested that it was because we have failed to invest in the cities, it is more that direct investment by the government has failed to produce the desired outcome. With the low income housing tax credit, you have a partnership that encourages both better quality building and far better management, and that is why a lot of us are concerned about it. In my own district, almost all of the affordable units have been possible in recent years due to low income housing tax credits. I share Mr. Salisbury's concern about the impact on qualified plans, particularly if we fix annuities and don't fix qualified plans. In either case, both annuities and qualified plans are very important instruments of promoting retirement security, which is frankly a very important goal for me as a

policy maker. So I just wonder—this was an excellent panel. I think we all learned a lot from it.

Mr. Shackelford and Mr. Salisbury and Mr. Godfrey, who wants to comment? Very briefly, if we went to one of Mr. Shackelford's alternatives, how does that affect the low income housing tax credit? How would that affect the qualified plans? Would its effect be any different than the proposal before us?

Mr. GODFREY. The effect would be the same.

Mr. SALISBURY. For practical purposes, vis-a-vis retirement plans and annuities, the effect would be the same.

Mrs. JOHNSON OF CONNECTICUT. Thank you very much. We appreciate you being here and appreciate the thoughtfulness of your testimony, and I think it is testimony that Members will think carefully about. The Committee stands in recess.

[Whereupon, at 11:25 a.m., the Committee was recessed, to reconvene on Tuesday, March 11, at 2:00 p.m.]

PRESIDENT'S ECONOMIC GROWTH PROPOSALS

TUESDAY, MARCH 11, 2003

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 2:00 p.m., in room 1100 Longworth House Office Building, Hon. Bill Thomas (Chairman of the Committee) presiding.

Chairman THOMAS. If our guests could find seats, please.

Today we begin the final segment of our four-part hearing to examine President Bush's plan to create jobs for American workers while growing and stabilizing the economy. Today's format will be different than the previous three segments of the hearing. We will hear from our congressional colleagues, who will be providing reactions as well as outlining possible alternatives or additions to reinvigorating the economy and creating jobs. This process is important because as Members begin to examine the President's plan, we want as broad an understanding of the reaction as possible, because as each Member reacts to the President's plan, who is not on this Committee, they are bringing information back from the people they represent in their districts across the United States.

We are pleased to have with us today the Chairman of the Rules Committee, the gentleman from California, David Dreier; the gentleman from Ohio, the Chairman of the Committee on House Administration, Bob Ney; and a newer Member of the collegiate workforce, Representative Marsha Blackburn of Tennessee.

Welcome. Thank you for your willingness to testify.

Seeing no Ranking Member, the Chair will indicate that if you have any written statement, it will be made a part of the record and you may address us in the time you have in any way you see fit.

These microphones are out of a previous era; you have to turn them on and speak directly into them. They are very unidirectional.

With that, I would recognize the Chairman of the Committee on Rules, the Honorable David Dreier.

[The opening statement of Chairman Thomas and Mr. English follows:]

Opening Statement of the Honorable Bill Thomas, Chairman, and a Representative in Congress from the State of California

Good afternoon. Today we begin the final segment of our four-part hearing to examine President Bush's plan to create jobs for American workers while growing and stabilizing the economy.

Today's format is different than that of the past three segments. We will hear from our Congressional colleagues, who will be providing feedback, as well as outlining possible alternatives to reinvigorate the economy and create jobs.

This set-up is a very important step in the process of helping Members of this Committee dissect the effects and outcomes of the provisions outlined as by the

President. Notably, these Members carry with them feedback from the people in their districts across the United States.

We are pleased to have with us today Rules Committee Chairman David Dreier of California; Representative Fred Upton of Michigan; House Administration Chairman Bob Ney of Ohio; and Representative Marsha Blackburn of Tennessee. Welcome—we look forward to your testimony.

Before we get started, I would like to first recognize the gentleman from New York, Mr. Rangel, for any comments he would like to make.

Opening Statement of the Honorable Philip S. English, a Representative in Congress from the State of Pennsylvania

Taken together, the President's tax proposals are an ideal prescription for economic growth and job creation. Lower tax rates will allow everyone to consume more and to invest more.

Similarly, removing the double tax on dividends will, through market capitalization, produce a wealth effect that will enhance both consumption and investment—the two engines of economic growth.

In my own view however, there are ways to improve the tax package the President has put before us. In particular, I would like to discuss some provisions to enhance its stimulative effects.

Homeland Investment Act

I have introduced *The Homeland Investment Act* (H.R. 767), along with the Chairman of the Rules Committee, Mr. Dreier, and my Ways and Means Colleague, Mr. Brady. The bill encourages companies to bring income earned abroad back to the U.S.—having a dramatic stimulative effect on the U.S. economy.

U.S. companies currently pay U.S. tax on foreign subsidiary earnings when they bring those dollars back to the U.S. At that time, the company pays the tax to the extent income taxes paid abroad are less than the full 35-percent U.S. tax rate. While many other countries fully exclude foreign dividends from domestic taxation, U.S. companies are left with only 65-percent of foreign earnings when they invest the foreign earning in the U.S. Alternatively, the U.S. companies can invest 100-percent abroad, and they do.

This is solely the result of the current U.S. tax rule. It is the equivalent of a U.S. investment tax credit for investing outside the United States—up to 35 percent. If a company came to us and asked us to enact current law, Congress would not agree. We should also not agree to continue the existing incentive to invest elsewhere.

The Homeland Investment Act provides a sensible and fiscally responsible alternative. In lieu of the deterring 35-percent rate, the Homeland Investment Act would effectively impose, for a limited period, a 5.25-percent toll tax on dividends from foreign subsidiaries. The 5.25-percent rate would only apply to excess of normal distributions. Companies must reinvest the funds in the U.S. to take advantage of the lowered rate.

To ensure that the money coming in is indeed taxed at the 5.25-percent rate, U.S. shareholders would surrender the right to claim foreign tax credits for 85% of foreign income taxes associated with dividends subject to the 5.25-percent tax. Moreover, U.S. shareholders would be required to exclude 85-percent of income subject to the 5.25-percent tax from the calculation of the foreign tax credit limitation.

The Joint Committee on Taxation estimated that this elective rule would increase tax revenues by $4.1 billion in the first year and reduce revenues by $3.9 billion over 10 years—a small cost relative to the economic benefits that would be derived from $135 billion in new corporate investment at home.

The projected $135 billion of new investment in America would have a far-reaching impact on the U.S. economy. This is just the stimulus the economy needs. Reinvestment of such money would provide additional funding in the United States for:

- Plant, equipment, and R&D;
- Pension plans depleted by decline in the stock market;
- Debt repayment, strengthening corporate balance sheets;
- Dividends to shareholders, which could productively be redeployed; and
- Raising equity market valuations by increasing funds for share repurchases.

This proposal brings investment back to the U.S., when we need it, immediately. U.S. industrial production hit its peak in mid-2000, and now two and one half years

later it is five percent under where it was. The economy is not performing up to its potential because a significant number of people and machines are not at work.

The number of people employed in the U.S. has fallen since its peak in 2001. We are 2.7 million jobs under where we were two years ago.

The $135 billion that Homeland Investment Act would bring into the U.S. is needed. The U.S. Department of Labor estimates that every $1 billion in direct foreign investment into the United States supports 20,000 workers at a salary of $50,000.

We can bring $135 billion into the U.S. economy this year at the reduced tax rate or continue to encourage those earnings remain overseas where they will never be taxed and where they are not invested in our economy.

I hope that many of my colleagues will join in the effort to include this cost-effective proposal in the final stimulus package.

Expensing

Second, I urge that we perfect the economic growth formula by adding 100-percent first-year expensing for all machinery and equipment placed in service within the next three years. A few weeks ago, I introduced H.R. 683 to accomplish just that.

The manufacturing sector has lost 2 million jobs since July, 2000; the trade deficit is nearly $38 billion; and capital expenditures remain in negative territory for the sixth quarter in a row.[1] Unless the current trend is reversed, manufacturing will almost disappear from America in the not too distant future and with it will go many of our high-paying, high-skill jobs. If they are to survive, American manufacturers must make big-dollar purchases of capital goods, but they need the lower cost and financing help that first-year expensing provides.

The excess manufacturing capacity that some people talk about is an excess of "yesterday's" outmoded plant and equipment that needs to be replaced as soon as possible. We have an under capacity in the latest state-of-the-art machinery that can compete with low-cost producers outside the U.S. An incentive in this area will undoubtedly spur investment in this sector and stimulate the manufacturing sector.

The revenue cost of first-year expensing for another three years is about $185 billion in the first year and rapidly declining thereafter. Over a ten-year period, the static revenue cost is $44 billion.

All elements of the President's tax package produce a large bang-for-the-buck in that they produce more GDP than they cost in tax revenues. According to the Fiscal Associates' econometric model, the President's rate reduction produces $2.50 of GDP for each $1 of revenue cost. Excluding dividends from double taxation produces $2.70 of GDP for each $1 revenue cost. Under this same econometric model, first-year expensing produces $9.00 of GDP for every $1 of revenue cost.[2]

Expansion of expensing produces significant results, has bipartisan appeal and will create jobs and growth.

Broadband

Third, I have introduced *The Broadband Internet Access Act* (H.R. 768) along with my colleague on the committee, Mr. Matsui. This bill provides tax incentives to businesses which deploy high-speed broadband internet access to underserved areas of the country.

The basic infrastructure that connects millions of Americans to the internet is quickly becoming outdated and cannot support the high-speed data transmissions available through broadband. A lack of investment in less affluent areas of the United States has lead to a burgeoning "digital divide" between rural and suburban America.

The Broadband Internet Access Act provides a 10% tax credit to companies providing current-generation broadband technology (1 mbps download and 128 kbps upload) to rural and low-income areas. The bill also provides a 20% tax credit to companies deploying next-generation broadband technology (22 mbps download and 5 mbps upload) to rural and low-income areas and residential areas throughout the country. Any company deploying broadband technology, whether via satellite, fiber optics, coaxial cable or copper wire, can qualify for the tax credits. The bill's tax incentives terminate five years from enactment.

The Joint Committee on Taxation estimates the cost of the legislation at $2.2 billion over 10 years. Moreover, the Brookings Institution estimates that the expansion of broadband technology across the country could generate nearly $500 billion worth of growth in the U.S. economy annually.

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[1] Patricia Panchak, "Manufacturing's Public Policy Challenge," *Industry Week*, March, 2002.

[2] "What's The Most Potent Way To Stimulate The Economy," IPI Issue Brief, October 10, 2001: Institute for Policy Innovation.

The Broadband Internet Access Act has attracted a broad array of support. A bipartisan coalition of 227 Members of the House of Representatives and 65 Senators cosponsored the bill in the 107th Congress. More than 100 different telecommunications, telemedicine, agriculture, civil rights and public interest organizations have endorsed the legislation.

Repeal the Tax on Unemployment Compensation

Finally, I have introduced legislation to place a two-year moratorium on the tax on Unemployment Insurance (UI) benefits (H.R. 798). As Americans struggle to recover from the recent economic downturn, it is more important than ever to repeal this unfair and inefficient tax.

The tax on UI benefits, enacted in 1986, penalizes individuals and families during the hardest of times. The Department of Labor estimates that 10 million people received unemployment benefits in 2002. While productivity is increasing in some markets, jobs are still being lost across the board—the recovery from unemployment is even worse than expected.

Come April, the unemployed will realize a tax liability as a result of having received those benefits. This legislation will protect such working individuals and families from facing this tax penalty during unemployment. The current tax treatment of unemployment compensation puts these payments on par with wages and other ordinary income with regard to income taxation. However, the UI tax is not a tax on income, it is a tax on benefits—benefits received during one of the most difficult times in a person's life.

It is unfair that no withholding is done during the dispensing of compensation, so individuals are hit with a tax penalty a year later, without any consideration of their financial stability. The tax on unemployment benefits strains taxpayers during their most vulnerable times.

There is broad bipartisan support for temporarily repealing this tax. Please join me in helping the victims of lay-offs get back on their feet.

I thank you for the opportunity to submit testimony. I commend the president for putting forward a strong proposal embedded in sound tax-policy. In addition, I urge your support for the aforementioned issues.

STATEMENT OF THE HONORABLE DAVID DREIER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. DREIER. Well, thank you very much, Mr. Chairman. It is nice to be on this side the table from you for the first time in a heck of a long time. Let me say, it is nice to be here with Mr. Crane and Mr. Camp, Mr. Hayworth, and Mr. Ryan. I am glad to see my friend, Mr. Levin, has arrived, making this a bipartisan effort. I want to say that I am very supportive of the President's plan, Mr. Chairman. Mr. Weller, nice to see you.

I hope very much that we will be able to maintain the package that the President has offered, intact. I think it is a very bold and dynamic growth package; and I have argued that there are some things that we can utilize, as you and I have discussed in the past, Mr. Chairman, that can make this plan even better. One of the things that I have testified before this Committee and talked all around about for a long period of time is the issue of capital gains.

We all know that every single time we have cut the capital gains tax in the past, we have seen a dramatic increase in the flow of revenues to the Federal Treasury. One of the best examples that we have used was the 1981 bill, where we brought about this reduction, and we saw a 500-percent increase in the flow of revenues to the Federal Treasury up until 1986. When we passed the 1986 Tax Reform Act and increased the capital gains tax again, and then we see a diminution of that the flow in revenues to the Treasury.

We know that getting to where I believe we should be, a zero capital gains tax, is probably not going to happen. Now maybe if we had a vote at this moment in the Committee, we might be able to be successful with it, but I still think it might face some other challenges.

So I began—as I looked at the President's great package, I said, Well, how can we make it even better and deal with this capital gain issue in a creative way? So some friends of mine and I sat down and started talking about this, and what I have introduced with—a number of Members of your Committee, Mr. Chairman, have cosponsored. You know, I have discussed it in the past, and it is a prospective cut in the capital gains tax.

Now, there are many people who argue if you cut the capital gain tax on all appreciated assets today, we would see a drop in the market because there would be this huge sell-off. This proposal, H.R. 44, in no way, in no way would create that kind of problem.

What I do is, I call for a cut in the top rate from 20 percent to 10 percent, 35 to 20 for corporations; and there is a 1-year holding period, so regardless of how you score the thing, the Federal Treasury ain't going to see a loss of revenues in that first year. There is a 2-year window during which time this purchase of a new investment needs to be made. The idea behind it, of course, is to get people into investing, create an incentive for them to get back into markets. Obviously we know, based on the track record that we have, that this would create an increase in the flow of revenues.

A 10-year scoring that was—just came out today by the Heritage Foundation showed there would be a $69.1-billion increase in the flow of revenues, $180 billion in new investment and 1 million jobs created in dealing with this sort of creative way to address capital gains. So I hope very much that this can be utilized as a way to build on the President's great proposal.

Another issue that I have been working on with a Member of your Committee, Mr. English, has to do with the issue of the foreign dividends deduction. One of the problems that we have is that there is a disincentive based on the Code right now that says to companies that have investments, operations, and income overseas that the tax right now is 35 percent on the dividends that are brought back—the earnings that are brought back here to the United States.

I think we need to encourage the opportunity to bring those earnings back and get them invested here in the United States. So, Mr. English and I have a bill, the Homeland Investment Act it is called, and I hope very much that that could be utilized here. I think that it, too, would create a wonderful opportunity for us to see strong and dynamic economic growth.

So I just want to say, Mr. Chairman, that I think that you have got a wonderful package before you. I have such confidence under your leadership in the work product that will end up coming before the Rules Committee, that we will anxiously look forward to; and I would just like to say that I hope very much that we will be able to include those items in this package.

I hope you understand, I have a meeting that I am representing—where I am representing you, Mr. Chairman, because I know that you can't be there; and so I have got to go back and rep-

resent the Thomas interest, which is always my top priority at every meeting I attend. So, I am not going to break with that today, and so I appreciate your understanding the extricacies of our schedules.

So thanks very much for having me.

[The prepared statement of Mr. Dreier follows:]

Statement of the Honorable David Dreier, a Representative in Congress from the State of California

Mr. Chairman, thank you for the opportunity to appear before the Committee today to discuss the President's economic growth proposal, as well as others, including my own, which I believe will provide an important stimulative complement to the President's plan and help grow our economy stronger faster, providing new jobs and opportunities for American workers, businesses, and investors. While I wholeheartedly support the President's plan, I also believe that inclusion of components that offer an incentive to increase capital spending in the near term, such as a prospective capital gains tax cut, overseas earnings repatriation, and accelerated depreciation are critical to providing a much needed, immediate, boost to those parts of the economy that are in the most need of help—investment and job creation.

Although recent indicators demonstrate that the U.S. economy is undergoing a slow recovery from the downturn of 2000, there are signs of weakness that continue to hamper growth. While productivity numbers have jumped at the fastest pace in years, the latest unemployment figures reinforce that much of our growth has been based on the use of existing resources, not new jobs and investment. Today, consumer spending, the backbone of the current recovery, shows signs of slippage. Individual investors, faced with the loss of $8 trillion in stock market wealth, continue to be wary, as further illustrated by the recent drop in worker participation in 401(k)s and other long-term investment and personal savings accounts. Simply put, our economy is growing, but not fast enough.

With this in mind, the President has introduced a plan that serves to provide both immediate and long term growth to our economy. To do this, the President's plan puts money back in the hands of consumers by accelerating tax relief, giving small businesses the room they need to grow, and providing incentives for capital investments.

Under the President's plan, 92 million taxpayers would receive an average tax cut this year of $1,083. It would come through an acceleration of the rate reductions passed in 2001, speeding up the marriage penalty relief in the same bill, and increasing the child tax credit from $600 to $1000. In my home state of California, that is 11 million taxpayers who will benefit, including 4 million married couples who will receive marriage penalty relief and 3 million families who will benefit from an increase in the child tax credit. These reductions were targeted at middle class taxpayers when they were approved last Congress, and they will provide immediate relief if they are implemented even sooner.

Mr. Chairman, as you know, America's small businesses create the majority of new jobs and account for fully half the total output of our economy. The President's plan would raise the equipment expense limitation for these firms to $75,000 from $25,000, providing much needed tax relief that will allow these companies to remain the driving force of our great economy. Lower taxes will help foster greater American entrepreneurship, allowing more investment for growth opportunities and creating more good jobs for American workers.

Importantly, the President's plan would also eliminate the unfair double taxation of dividends. Everyone who invests in the stock market and receives dividend income—especially seniors who often rely on those checks for a steady source of retirement income—will benefit from elimination of the double taxation on dividends. It is estimated that enacting this important component of the President's plan would return about $20 billion this year into the economy.

All together, the President's proposal provides a critical step towards growing our economy faster, helping to maintain our long term prosperity. I believe that it is important that the Congress move immediately to pass his plan.

However, while I fully support the President's proposal, I believe that we can do even more to boost the economy and create jobs for more Americans.

Although business productivity has improved over the past year, increased worker efficiency is not nearly enough to sustain strong economic growth. In order to get more Americans back on the job, we need to implement incentives that will make our economy grow at a much faster rate, thereby increasing the demand for new goods and services—and the workers who produce them.

Right now businesses are responding to economic uncertainty by placing a freeze on hiring and wringing as much productivity out of their businesses as possible. While our economy has experienced moderate growth, most of that can be accounted for through gains in productivity as a result of layoffs and better utilization of existing resources.

The key to strong and sustained economic growth is to encourage businesses to increase capital investment that will lead to expansion and job creation. Companies that undertake bold new business initiatives require a larger workforce, thus providing more Americans with opportunities to attain stable employment and provide for their families. For example, during the unprecedented economic expansion of the mid to late 90's, much of our economic growth was attributed to entrepreneurial activities. According to the National Venture Capital Association (NVCA), between 1995 and 2001, venture capitalists financed an average of 1,700 brand new companies per year. In 2002, only 706 companies received their initial round of venture financing. NVCA estimates that today, more than $85 billion in venture capital is sitting on the sidelines waiting for investment opportunities. We need to get that capital into the economy, where it will help turn innovative ideas into reality, create new jobs for American workers, and produce new goods and services for consumers here at home and around the world.

One of the most effective ways to boost business expansion, create jobs, and bring individual investors back into the markets—to grow the economy—is to immediately target capital investment. Legislation I have introduced, H.R. 44, the "Investment Tax Incentive Act of 2003" would do just that. H.R. 44 creates a two-year window of opportunity in which assets purchased during that time will lock-in a reduced capital gains tax rate when they are sold. The capital gains tax rate for investments purchased during the two-year window would fall from 20 percent to 10 percent for individuals and 35 percent to 20 percent for businesses. Investments must be held for one year to qualify for the lower rates. Purchases which qualify under Section 1202 (Qualified Small Business Stock) would have an effective rate that falls to 7%.

Importantly, I believe this forward-looking proposal will reinvigorate business investment while also bolstering the investment holdings of the 50% of Americans—the Investor Class—who own some type of financial asset to help pay for their children's education, buy a first time home, or plan for their retirement. These investors understand that they have a direct stake in America's continuing prosperity. Their stocks, mutual funds, and 401(k)s fund the ideas, technologies, and businesses that drive the economy. By providing an incentive to get them back into the market, we can create and expand the businesses that put workers back on the job.

Lowering the future capital gains tax rate for new investments will increase the value and price of assets. This will give markets a boost and raise portfolio values. The two-year time frame creates a further incentive to buy now, providing near-term stimulus. Finally, lower capital costs for business will allow companies to purchase the plants, machinery, and other equipment needed to expand and create new jobs.

This targeted proposal also includes a special benefit for the entrepreneurial small firms that are an "engine of growth" among American businesses. In my home state of California, many of the corporate cornerstones of the Information Age started in the garages of pioneers like Steve Jobs and David Packard. They relied then on access to capital to turn great technology ideas into great high tech businesses, and early venture funding is just as critical today.

Some critics of a broad capital gains tax reduction have made the claim that cutting this tax rate would encourage investors to sell assets to take advantage of the tax cut. They claim this would actually drive down markets, the last thing investors want to see. That argument fails to take into account the fact that lowering the capital gains "tax on investment" would increase the demand side of the investment equation. But, this proposal takes that whole argument off the table. The forward-looking nature of this investment window is a strong incentive to buy. Rather than downward pressure on the market, we would see momentum for a rising market and increased wealth—direct relief for individual investors who have weathered an $8 trillion drop in the stock market.

Mr. Chairman, my proposal would not only provide the much needed stimulus our economy needs to grow faster and create new jobs, it will also be good for the federal treasury. According to a preliminary score by the Joint Committee on Taxation, the Investment Tax Incentive Act would increase budget receipts by $100 million in the first year and $600 million in the second year. In addition, a preliminary score by The Heritage Foundation estimates that my proposal would increase budget receipts by $66.7 billion in 2004 and $28.9 billion in 2005. Over a 10-year period, The Heritage Foundation analysis estimates that there would be a $69.1 billion increase in federal capital gains receipts. Like the last time we cut the capital gains tax rate

in 1997, a faster growing economy and increased investor activity will quickly put to rest any arguments that such a move would cut revenue.

Several other proposals have been introduced that also demonstrate the ability to increase capital investment and strengthen the economy. Specifically, H.R. 767, the "Homeland Investment Act", introduced by Congressman English, of which I am an original co-sponsor. Under the current IRS code, U.S. companies are required to pay tax on foreign subsidiary earnings when these earnings are brought back to the U.S., to the extent of any shortfall in the tax paid abroad and the 35% U.S. tax rate. Thus, U.S. companies realize only 65% of their hard earned income from overseas investments, thus deterring them from bringing these funds home. The proposal would effectively impose, for a one-year period, a 5.25% toll tax on dividends in excess of normal distributions from foreign subsidiaries, thereby encouraging U.S. companies to bring back their earnings from international holdings for investment here at home.

I applaud the President's plan which provides much needed tax relief for all Americans and boosts the economy. I also believe that the addition of my capital gains tax cut proposal to the President's plan will enhance short-term stimulative effects and help foster faster economic growth, financial prosperity for America's Investor Class, and new jobs for American workers.

I look forward to continue working with the President and you, Mr. Chairman, to craft an effective economic growth package. Thank you.

February 12, 2003

The Honorable David Dreier
United States House of Representatives
237 Cannon House Office Building
Washington, DC 20515

RE: The Investment Tax Incentive Act of 2003

Dear Representative Dreier:

On behalf of the National Venture Capital Association (NVCA), I commend you for your introduction of H.R. 44, "The Investment Tax Incentive Act of 2003." I write to offer our support for this important legislation. It will help bolster desperately needed financing for our country's small, entrepreneurial companies, which create the majority of new jobs in this country.

I have participated in numerous formal and informal roundtable discussions with industry representatives, academics and policy makers regarding challenges faced by U.S. entrepreneurs and the role the Federal Government can play in contributing to their success. These discussions generated an indisputable consensus that access to adequate capital is an enabling element to a successful entrepreneurial venture. And simply stated, if the capital gains rate is lowered the amount of investment increases.

There has been a dramatic slowdown in new investments by venture capitalists, since 2001. Between 1995 and 2001 venture capitalists financed an average of 1,700 brand new companies per year. But last year only 706 companies received their initial round of venture financing. Furthermore, NVCA estimates that nearly $85 billion of venture capital is sitting on the sidelines looking for investments. This targeted bill is effectively crafted to avoid the usual criticisms of a capital gains cut. By making it prospective there is no incentive to cash out of current investments; in fact, just the opposite, it brings new money into play.

NVCA represents more than 460 professional venture capital firms located throughout the United States. Most of the companies in which we invest are in the high tech arenas of the Internet, telecommunications, medical devices, and biotechnology. These sectors are now the bedrock of our economy and are literally changing the ways we work and live. It should be a national priority that we encourage these companies to expand and prosper.

I commend your leadership on this issue and I look forward to working with you to pass this important legislation.

Sincerely,

Mark G. Heesen
President

March 5, 2003

The Honorable David Dreier
United States House of Representatives
Washington, DC 20515

Dear Mr. Chairman

The Financial Services Roundtable thanks you for your introduction of H.R. 44, the "Investment Tax Incentive Act of 2003." The Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Roundtable member companies provide fuel for America's economic engine accounting directly for $18.3 trillion in managed assets, $678 billion in revenue, and 2.1 million jobs.

H.R. 44 will boost business expansion, create jobs, and bring individual investors back into the markets by immediately targeting capital investment. The bill creates a two-year window in which assets purchased will be subject to a reduced capital gains tax rate when they are sold. Capital gains rates for investments purchased during the two-year window would fall from 20 percent to 10 percent for individuals and from 35 percent to 20 percent for corporations.

H.R. 44 will generate revenue and revitalize our economy by encouraging capital investment with the lower capital gains on new asset purchases. Thank you again for your leadership on H.R. 44, the "Investment Tax Incentive Act of 2003."

If I can be of any assistance on this or any other matter, please contact myself or Scott Talbott at 202–289–4322.

Best regards,

Steve Bartlett
President

February 4, 2003

The Honorable David Dreier
237 Cannon House Office Building
Washington, DC 20515

Dear Chairman Dreier:

I am writing to express Americans for Tax Reform's support for the Investment Tax Incentive Act of 2003.

As you know, the most effective way to restart economic growth is to reduce taxes on capital. The reduction of capital gains, as proposed by the Tax Incentive Act will boost business expansion, create jobs, and bring individual investors back into the market. As such, the legislation if enacted, will have a significant impact restarting economic growth in America.

Moreover, the importance of financial markets cannot be understated. With nearly 52 percent of Americans invested in the market, the economy has become more dependent on the stock market. Your legislation will help boost investor confidence and regain some of the $7 trillion of value lost in the markets since March 2000.

On behalf of Americans for Tax Reform, I wholeheartedly endorse the proposal. This initiative is the right course for limiting the tax burden on American families.

Thank you for sponsoring this important legislation.

Sincerely,

Grover G. Norquist
President

Chairman THOMAS. Thank you very much. I appreciate your focus on capital gains. It is an important component.

We have asked the Joint Tax Committee to examine the proposal that you have introduced with Congressman English. We believe their revenue flow estimates are not correct, and we are going to continue a dialogue with them to get a little better idea of what they believe it raises and it costs over a 10-year period. So we appreciate very much the work that you have put in, especially in the capital gains area.

Say hello to the people for whom you are doing my work.

Mr. DREIER. Absolutely, I will.

Chairman THOMAS. The gentleman of the Committee on House Administration whom we will all be visiting with briefly in the capacity of that Committee's reviewing the authorizing Committees' budgets.

The Chair listens intently to the gentleman from Ohio as he presents his concerns about the tax bill

STATEMENT OF THE HONORABLE ROBERT W. NEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. NEY. Thank you, Mr. Chairman, Members of the Committee. Also wanting to fall in line with my colleague, Mr. Dreier, we will be very—I guess you would say "working for the Chairman," and if the last Chairman of the Committee couldn't get these microphones upgraded, I commit to you I will try. That is a joke.

So I just—thank you, Mr. Chairman, for the opportunity to be here today to discuss with you the low-income housing tax credit and the role it plays in helping to create affordable housing for lower-income households.

This country is facing a growing affordable housing crisis for low- and moderate-income families. Despite the fact that more and more people are sharing in the American dream of home ownership, many working families are finding it difficult to find affordable rental housing. The high cost of construction and the shortage of land have forced many builders to focus on only the high-end market. That is why we have to look for ways to improve these barriers that make it more costly or difficult to meet the demands of the low- and moderate-income housing market.

As the new Chairman of the Financial Services Subcommittee on Housing and Community Opportunity, I am also committed to see that we preserve the affordable housing that currently exists and to work to create more affordable housing across the United States. One of the major engines for subsidizing the production of assisted rental housing to make it affordable to low-income households is the low-income housing tax credit.

On January 7, of course, President Bush unveiled his job creation and economic growth package designed to provide important changes to many current tax provisions. I want to make it clear that I support the President's stimulus package. I applaud the efforts of the Chairman of the Committee in doing something about the economy of the United States. I am sure the plan will stimulate economic growth and will create new jobs while reducing unfair burdens on American investors. Our country is still trying to recover from last year's recession and this plan will help spur that recovery.

More specifically, I strongly support eliminating the double taxation on dividends, as well as making the phasing of income tax relief for all Americans immediate. The double taxation of dividends unfairly punishes investors and discourages people from putting capital into our markets that could be used to fund new economic growth, exactly the opposite of what our economy needs right now.

However, I did want to bring to the Committee's attention an issue that could have a unintended impact on various tax credit

programs designed to promote affordable housing. As I mentioned, in the President's plan as introduced is a proposal to eliminate the double taxation of corporate dividends. Beginning in 2003, dividends paid by corporations to their shareholders would be tax free when paid from earnings previously taxed at the corporate level. In short, corporations that pay higher income taxes will be able to distribute more tax-free dividend income than corporations that have reduced their tax burden.

While there are many significant benefits to this change, it is important I think that we understand all the implications for a change in the Tax Code. Over the years, various tax credits have been enacted specifically to encourage community reinvestment such as the low-income housing tax credit, the new markets tax credit, and the historic preservation tax credit, to name a few. Perhaps the largest of those programs is the low-income housing tax credit. I just want to take a moment to highlight the importance of this program.

Since it was created in 1986, the low-income housing tax credit program has produced over 1.6 million units of affordable housing. Two years ago Congress expanded this program so it is now producing over 115,000 units annually. In my home State of Ohio, we are seeing 3,500 units of affordable housing produced every year because of tax credits. I believe the tax credit program is one of the best ways to involve the private sector in affordable housing.

Congress has developed a fiscally responsible way to provide corporations an incentive to put money into affordable housing. This is the way the government should do business.

Concerns have been raised that the President's dividend tax proposal could have an adverse effect on these affordable housing tools. It is estimated that corporate investment accounts for more than 98 percent of the equity capital generated by the housing credit makes this affordable rental housing possible. The theory is simply that under the economic stimulus plan, corporations would forgo housing credit investments in favor of maximizing the distribution of tax-free dividends to shareholders.

Again, while I support the President's efforts to stimulate the economy and eliminate the double taxation on dividends, the effect on the low-income housing tax credit and other tax credit programs is an issue, I believe, that deserves our deliberate attention as we move forward with the President's economic stimulus package.

So that is simply, Mr. Chairman, what I am pointing out today. I do appreciate the Chair's work on this issue and the President's plan.

Chairman THOMAS. Thank you very much. Is the Chair correct in assuming that the Chairman is able to stay following the other Members testimony for questions?

Mr. NEY. Yes, sir.

[The prepared statement of Mr. Ney follows:]

Statement of the Honorable Robert W. Ney, a Representative in Congress from the State of Ohio

Thank you for the opportunity to be here today to discuss with you the Low Income Housing Tax Credit (LIHTC) and the role it plays in helping to create affordable housing for lower income households.

This country is facing a growing affordable housing crisis for low and moderate-income families. Despite the fact that more and more people are sharing in the American dream of home-ownership, many working families are finding it difficult to find affordable rental housing.

The high cost of construction and the shortage of land have forced many builders to focus on only the high-end market. That is why we must look for ways to remove those barriers that make it more costly or difficult to meet the demands of the low and moderate income housing market.

As the new Chairman of the Financial Services Subcommittee on Housing and Community Opportunity, I am committed to seeing that we preserve the affordable housing that currently exists and to working to create more affordable housing across the country.

One of the major engines for subsidizing the production of assisted rental housing affordable to lower income households is the Low Income Housing Tax Credit (LIHTC).

On January 7, President Bush unveiled his job creation and economic growth package designed to provide important changes to many current tax provisions. **I want to make it clear that I support the President's stimulus package. The plan will stimulate economic growth that will create new jobs while reducing unfair burdens on American investors. Our country is still trying to recover from last year's recession, and this plan will help spur that recovery. More specifically, I strongly support eliminating the double taxation of dividends, as well as making the phase in of income tax relief for all Americans immediate. The double taxation of dividends unfairly punishes investors and discourages people from putting capital in our markets that could be used to fund new economic growth, exactly the opposite of what our economy needs right now.**

However, I want to bring to your attention an issue that could have an unintended impact on various tax credit programs designed to promote affordable housing. As I mentioned, in the President's plan, as introduced by Chairman Thomas, is a proposal to eliminate the double taxation of corporate dividends. Beginning in 2003, dividends paid by corporations to their shareholders would be tax-free when paid from earnings previously taxed at the corporate level. In short, corporations that pay higher income taxes will be able to distribute more tax-free dividend income than corporations that have reduced their tax burden. While there are many significant benefits to this change, it is important that we understand all the implications for such a change in the tax code.

Over the years, various tax credits have been enacted specifically to encourage community reinvestment, such as the Low Income Housing Tax Credit (LIHTC), the New Markets Tax Credit and the Historic Preservation Tax Credit to name a few.

Perhaps the largest of those programs is the Low Income Housing Tax Credit. I want to take a moment to highlight the importance of this program. Since it was created in 1986, the Low Income Housing Tax Credit program has produced over 1.6 million units of affordable housing. Two years ago Congress expanded this program so that it is now producing over 115,000 units annually. In my home state of Ohio we are seeing 3,500 units of affordable housing produced every year because of tax credits.

I believe that the tax credit program is one of the best ways to involve the private sector in affordable housing. Congress has developed a fiscally responsible way to provide corporations an incentive to put money into affordable housing. This is the way government should do business.

Concerns have been raised that the President's dividend tax proposal could have an adverse effect on these important affordable housing tools. It is estimated that corporate investment accounts for more than 98 percent of the equity capital generated by the housing credit that makes this affordable rental housing possible. The fear is that under the economic stimulus plan corporations would forgo housing credit investment in favor of maximizing the distribution of tax-free dividends to shareholders.

While I support the President's efforts to stimulate the economy and eliminate the double taxation on dividends, the effect on the Low Income Housing Tax Credit and other tax credit programs is an issue that deserves our deliberate attention as we move toward passage of the President's economic stimulus package.

It is important that we make sure we understand the consequences of the President's proposal and that we make the necessary changes prior to passage to alleviate any negative effects the dividend tax exemption proposal might have on our ability to provide affordable housing for low and moderate families across the country.

Thank you again for the opportunity to be here today and I stand ready to work with you in the weeks ahead to pass an economic stimulus package that will not

only jump start our economy but will also maintain the important tools necessary to promote the goal of providing sufficient affordable housing.

Chairman THOMAS. Thank you very much. The Chair would then recognize the Honorable Marsha Blackburn from Tennessee for any statement she may wish to make.

STATEMENT OF THE HONORABLE MARSHA BLACKBURN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TENNESSEE

Mrs. BLACKBURN. Thank you, Mr. Chairman and welcome back from Tennessee. We are glad you had the opportunity to visit our fair State. Thank you for calling this hearing to allow Members the opportunity to testify on items that should be included in this Committees' economic growth package.

I support the President's economic growth package because it will provide many immediate and long-term economic benefits with much-needed provisions for small business owners today. I want to testify about a separate item that deserves inclusion in the final plan.

Current U.S. tax law allows individuals living in jurisdictions with State and local income taxes to deduct the amount they pay in such levies from the amount of income subject to Federal taxation. The Income Tax Code, however, does not allow individuals who live in States or localities with sales taxes to choose to deduct those tax payments from their Federal income tax base.

This situation is inequitable. Residents of States whose leaders have shown the fiscal restraint to avoid adopting a State income tax should not be punished; this is simply an issue of tax fairness.

To remedy this situation, I have joined with more than 65 of my colleagues to support legislation put forward by Representative Brady that would reinstate that deduction. H.R. 720 gives taxpayers the option to either deduct the State and local income taxes or State and local sales taxes. Those living in States that have an income tax would still be able to make that income tax deduction as they do today.

By providing this option to take one of the two deductions, the impact on the Treasury would be minimized and residents in States like mine would be provided with an equitable remedy. If Tennesseans could deduct their sales tax, it would mean an addition of 1 billion into the economy for the people of Tennessee.

This is a bipartisan bill that has been cosponsored by eight Members of your Committee, Mr. Chairman. It is my hope that the inclusion of this item in the final economic stimulus package could bring bipartisan support in this Committee and on the floor of the House.

Mr. Chairman, thank you for the opportunity to testify before your Committee.

[The prepared statement of Mrs. Blackburn follows:]

Statement of the Honorable Marsha Blackburn, a Representative in Congress from the State of Tennessee

Thank you Mr. Chairman for calling this hearing to allow members the opportunity to testify on items that should be included in this committee's economic growth package.

I support the President's economic stimulus package because it will provide many immediate and long term economic benefits, with much needed provisions for small business owners. Today, I want to testify about a separate item that deserves inclusion in the final plan.

Current U.S. tax law allows individuals living in jurisdictions with state and local income taxes to deduct the amount they paid in such levies from the amount of income subject to federal taxation. The Income Tax Code, however, does *not* allow individuals who live in states or localities with *sales* taxes to choose to deduct these tax payments from their federal income tax base.

This situation is inequitable. Residents of states whose leaders have shown the fiscal restraint to avoid adopting an income tax should not be punished. This is simply an issue of tax fairness.

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According to our state Comptroller, if Tennesseans could deduct their sales tax it would mean one billion dollars for the people of our state.

This is a bipartisan bill that has been cosponsored by seven members of your committee, Mr. Chairman. It is my hope that the inclusion of this item in the final economic stimulus package could bring bipartisan support in this committee and on the floor of the House.

Mr. Chairman, thank you for the opportunity to testify before this committee.

Chairman THOMAS. Thank you. Now we turn to the gentleman from Michigan, Mr. Upton. Thank you for joining us; we are interested in hearing what you have to say. Any written testimony will be made a part of the record.

STATEMENT OF THE HONORABLE FRED UPTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. UPTON. Thank you, Mr. Chairman and I will do exactly that and summarize my statement briefly.

Mr. Chairman, back this March of 2002, President Bush signed the Job Creation Worker Assistance Act into law, and that included legislation that allowed businesses to utilize the first-year 30 percent accelerated depreciation. The tech industry was often viewed, particularly from 1994 to the year 2000, as the engine of the economy. It has now become an anchor because things have been really tough. With this legislation that Mr. Weller and I introduced, H.R. 771, of which we have some 82 cosponsors thus far, we allow businesses to depreciate 100 percent of their equipment purchases over the next 18 months.

Now, why is this important? Well, if you read today's front page of the Wall Street Journal, a story written by William Buckley, he writes this:

"The chief information officer of the telephone giant Verizon Communications was reviewing this year's technology budget with

his top lieutenants in late January. He didn't think that their savings projections were ambitious enough. They told him $20 million would be lopped off large computer purchases. 'Not enough,' he says; 'we saved $100 million last year.'

"One of his top aides protested that Verizon did such a phenomenal job of vendor squeezing in '02 that there is not much more to squeeze. 'Squeeze harder,' he admonished; 'see how much you can push things.'

"Well, that attitude is bad news for IBM, Hewlett Packard, Sun Microsystems and other big technology sellers. Unfortunately for them, it is a widespread attitude not expected to change soon."

Mr. Chairman, H.R. 771 will change that. I mean, from today's bad news in the Wall Street Journal, when you look at the statistics and the graphs in terms of investment in high-tech equipment, you can see that every year it was coming down until the Weller-Upton legislation was enacted into law last year and it began to come back up.

We want this—these bars to continue to go up, and we know that this bipartisan legislation will help in a major way. I would like to say on behalf of Mr. Weller, but certainly for me, that we would like to see this bill included as part of the package that this Committee will vote on in the next couple of weeks and get to the House floor.

I yield back the balance of my time.

[The prepared statement of Mr. Upton follows:]

Statement of the Honorable Fred Upton, a Representative in Congress from the State of Michigan

Mr. Chairman—

Thank you for the opportunity to testify on HR 771, the Full Expensing for Economic Growth Act of 2003. I appreciate the opportunity to testify before the Ways and Means Committee. I am very pleased to have worked closely on this bill with my good friend from Illinois, Congressman Weller.

There is no question that our economy is in a rut. Congress must take the necessary steps to jumpstart the economy back into a period of significant growth. We can do more to stimulate the economy, and accelerated depreciation is part of the prescription that will get our economy moving again.

Last year, Congressman Weller and I introduced similar legislation, H.R. 2981 to establish a 2-year recovery period for depreciation of computers and other technological equipment, a 24-month useful life for depreciation of computer software, and a 7-year useful life for the depreciation of certain auction-acquired telecommunications licenses. This legislation had 57 cosponsors, including 6 Members of this Committee.

Why the emphasis on accelerated depreciation? Well, the numbers do not lie. On March 9, 2002, President Bush signed the Job Creation and Worker Assistance Act into law. This important legislation allowed businesses to utilize a first-year 30 percent accelerated depreciation allowance. As this chart shows, the four quarters preceding the new law experienced consistent decline in the investment of high-tech equipment. Upon the president signing the bill, investment quickly improved and we have seen 4 consecutive quarters of increased investment in high-tech equipment. And I am confident that the trend will continue.

But why is this important? The answer is simple. From 1994 to 2000, the information technology (IT) industry served as the uncontested "engine" of economic expansion in the U.S. Although it comprises 8 percent of the U.S. economy as a whole, the IT sector accounted for nearly 30 percent of real growth in the Gross Domestic Product (GDP) over that period, a greater contribution than any other sector of the economy, including retail trade, services and transportation.

IT investment drove this boom, with real private investment in information processing equipment and software growing at an average annual rate of 32 percent from 1994 through 2000. Investment in computers and peripheral equipment grew at an astounding 131 percent average annual rate.

During the 1990s, U.S. businesses poured more than $2 trillion into computers, software and other technological products. As you know, most computers and other technological equipment currently have a 5-year depreciation life. The current 5-year lifetime for depreciation of computers/high tech equipment is clearly outdated. A 5-year depreciation schedule for business computers and equipment is no longer realistic in today's economy.

As Chairman of the House Energy and Commerce Subcommittee on Telecommunications and the Internet, I am very concerned with the economic heath of the high-tech sector, and there is no question of that our bill will help spur growth.

The new law allows businesses to accelerate the depreciation of equipment they purchase between September 11, 2001 and December 31, 2004. They get to accelerate 30% more in the first year. Before this law, a $1000 computer would be depreciated equally over 5 years. $200 each year. With this change, businesses get $200 in the first year, plus a 30% bonus. So, they depreciate $500 in the first year and the remaining $500 over the next four years ($125 each year for four years).

Congressman Weller and I believe this is the right way to stimulate the economy. To this end, on February 13, 2003, we introduced legislation to "speed up" accelerated depreciation even further (HR 771, introduced 2/13/03 with 82 cosponsors).

With our new legislation, businesses could depreciate 100% of their equipment purchases over the next 18 months. All of the assets covered under the Job Creation and Worker Assistance Act would apply. Generally, all assets with depreciation lives of 20 years or under would apply.

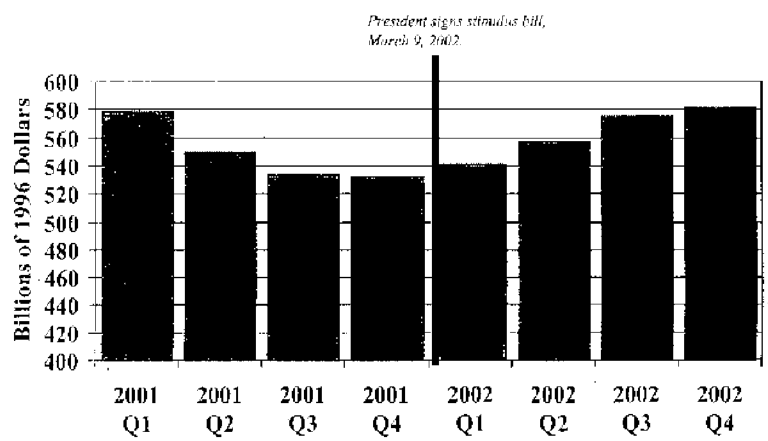
This is 100% expensing. We believe this would provide an immediate boost to the economy by encouraging businesses to purchase equipment this year and next year. This will create jobs and help Americans keep their jobs. According to research done by the Institute for Policy Innovation, "100 percent first year 'expensing' can be expected to produce $9 of additional economic output for every dollar it costs in lost revenue."

The economic growth plan introduced by President Bush in January 2003, does not change the accelerated depreciation provisions at all. His proposal does increase small business expensing for new investment by allowing small businesses to immediately deduct $75,000 (currently $25,000) beginning in 2003.

Mr. Chairman, I would ask that as the Committee considers ways to grow the economy over the next 18 months, it consider my proposal to allow for 100% expensing of equipment until September 2004. This is a common sense solution to that will quickly infuse cash into the economy.

Thank you for your consideration of my testimony. I would be happy to answer any questions.

Investment in High-Tech Equipment*



Source: Bureau of Economic Analysis, National Income Product Accounts

* Real Private Investment in Information Processing Equipment and Software

Chairman THOMAS. Thank the gentleman. I am asking staff to see—do we know if there is a score that Joint Tax has produced on 771? Mr. Weller?

Mr. WELLER. Mr. Chairman, we have submitted a request, but we have not been given a formal score yet.

Chairman THOMAS. You don't have that yet.

Given the magnitude and the boldness which the Chair indicates might be necessary in terms of a stimulus package, especially compared with the President's component, we would be most interested in what the score is.

For example, the gentlewoman from Tennessee's proposal, we believe, is somewhere in the vicinity of $30 billion over 10 years on creating an either/or between income and sales tax at the State and local level. I have a hunch your legislation, Mr. Upton, carries a fairly significant price tag, because I believe it is fairly significant legislation, and we just need to get those numbers before we can begin to come down on one side or the other.

Mr. UPTON. Well, if you could help us get those numbers—I know we sent a letter.

Chairman THOMAS. We are going to do just that. Mr. Ney, you should find some form of comfort that yours is not a voice in the wilderness about the credit aspect of the President's plan. We have had testimony in virtually every session that we have had.

Also, it isn't just the low-income; there are energy credits, which have been noted, that would be affected. The difficulty is getting

a feel for exactly to what extent would they be affected; and we are doing the best that we can right now to get an understanding of, if there is in fact a decimating effect, whether it makes it difficult, whether or not it is absorbing these bumps in business as usual.

You have a feeling it is somewhere along a continuum, and these are as significant as the protestors or as insignificant as the advocates. Just where on that continuum, I think, is something that we need to know, and then begin to take that into consideration as we examine the President's structure.

I appreciate your registering your concern on that issue as well.

Mr. NEY. Thank you, Mr. Chairman. I think that approach is very fair and balanced.

Chairman THOMAS. Does the gentleman from Illinois wish to inquire?

Mr. CRANE. Not so much to inquire, but to congratulate the witnesses here for their introduction of good legislation and to let them know that I think I am a cosponsor, aren't I, of yours, Fred?

Mr. UPTON. Yes, sir. It is actually Mr. Weller's bill; it is Weller-Upton. I think you are.

Mr. CRANE. I think David Dreier's, I am a cosponsor of too.

I don't know that I am a cosponsor of Marsha's. I agree with her totally on what she is trying to do. The question I have—and unfortunately Marsha has left us—is how do you calculate sales taxes? How do you keep track of the sales taxes?

Chairman THOMAS. You could obviously keep records, but as I recall—and I stand willing to be corrected, but in the old days, you had charts in the tax booklets which gave you amounts which you could utilize, reasonable amounts for various States, based upon the tax that you paid, to determine roughly the amount that you could deduct. It was not a totally accurate procedure.

Mr. CAMP. It was like a standard deduction?

Chairman THOMAS. Yes. It changed from State to State based upon the levies made. As I recall, it may have been only the State level and not the State and local. So, you could do an approximation, or you could save all your receipts which would be gargantuan in this day and age.

Mr. CRANE. No, I have always believed that taxes should be raised in the simplest but most painful possible way so everyone is painfully aware of what he is paying in taxes. Sales taxes, to me, have always been stealth taxes, a way of hiding the tax revenue that is being gained by government every time you go out and make a purchase; and the average person isn't even aware of it when he is buying products.

This is a concern to me as to how you would adequately offset that, give that same kind of tax relief to individuals or the States.

At any rate, I commend all that you are doing, and I support all of your efforts and yield back the balance of my time.

Chairman THOMAS. I thank the gentleman. Does any other Member wish to inquire of the Members? The gentleman from Michigan.

Mr. CAMP. Thank you, Mr. Chairman. Fred, does your bill apply to any equipment or just high-tech equipment? You had given the high-tech——

Mr. UPTON. It is all equipment.

Mr. CAMP. All business equipment?

Mr. UPTON. You know—and actually I would like to see it expanded. I spoke to the American Dental Association this morning at their nationwide conference, and for many of them they have leased equipment, and again they—the way that the tax law is structured for them, I think it is over a 30-year, 34-year span, so—but this is all equipment. Obviously, it would impact the high-tech side in a major way, as the Wall Street Journal pointed out this morning.

Mr. CAMP. To the extent that you get your score from Joint Tax, I notice in your testimony you talk about some research done by the Institute for Policy Innovation, that 100 percent first-year expensing can be expected to produce $9 of additional economic output for every $1 it costs in lost revenue. So, to the extent that you can get that message out, I think this would be helpful to your——

Mr. UPTON. That is what we would like to do.

Mr. CAMP. To your bill.

Chairman THOMAS. The gentleman from Illinois.

Mr. WELLER. Thank you, Mr. Chairman. It is good to see my friend and classmate, Chairman Ney. I am going to direct my question to my colleague, Mr. Upton.

First, Fred, let me just say thank you for the opportunity to work with you on the legislation you have brought before our Committee to discuss.

You know, I think Mr. Camp really hit the nail on the head by pointing out the economic impact of 100-percent expensing in the first year. A $9 economic impact for every $1 of cost to the Treasury is a tremendous impact if we are looking for essentially a jump start or a kick start to get this economy moving again you know. Of course, Fred, you and have I districts that are somewhat similar. You are in southwestern Michigan and I am in the south suburbs of Chicago, but a lot of our employers are smaller manufacturers. Usually they are family held and they have been there several generations and they employ 200 to 300 people on the side of town. They are the sole employer for many of our communities.

Mr. UPTON. Even employers that employ as few as 50 people—I was at a small business in Kalamazoo 2 weeks ago. They have gone from 55 employees to 25. This is a company that makes boxes that package beer and cereal and everything else. This provision, if we are able to get it enacted, would probably bring back many of the people they have had to lay off.

Mr. WELLER. Well, if the gentleman would yield, one thing I hear from the employers in my district is that, you know, many of them have delayed replacing equipment—whether a delivery vehicle or telecommunications equipment, the office computer, machine tool—and they believe that full expensing would give them the incentive to replace that equipment. Of course, there is a worker somewhere in Michigan or Illinois or elsewhere in this country that makes it.

I know Mr. Camp asked the question, what assets would be affected by this. The same identical assets that are currently benefiting from the 30 percent expensing provision that was in the stimulus package a year and half ago, including inside build-out, tenant improvements, and real estate.

What are your—you know, your business leaders and workers saying back home regarding what kind of impact they believe expensing could have?

Mr. UPTON. They have come to me. We have put out some notice that I am pursuing this, and we have had a number of businesses call our offices and say, this will help, this will bring back the unemployed workers, the folks that we have reluctantly had to let go. I would hope that they stay in the area.

If you can get this thing through, this is going to be an immediate jump start, just like this table showed, where, when the President's signed stimulus package into law, and we immediately began to see an investment in high tech. Whether it be the large companies, like Hewlett Packard or Cisco or Nortel, companies like that in terms of things that they actually produce.

As the Journal said this morning, every company is looking at this downturn and when is it going to end. This as a piece of the stimulus package will provide immediate growth and bring unemployed folks back into working again.

Mr. WELLER. If the gentleman would yield, you know, one area where I have seen—where there is a great interest in greater investment, as well, is in the whole issue of security.

Now we tend to forget the vast majority of institutions, buildings, offices, factories, manufacturing facilities are in private hands; and every manufacturer—or, excuse me, every manager—in America, after September 11, was thinking, what do I need to do to make my business more secure for my workers, my family, my customers, those whom I serve with our business? Many of these companies are now investing in improved security. Of course, by allowing them to expense or fully deduct 100 percent, that encouraged them to make the investment to essentially—you know, for private homeland security.

It also helped them absorb the cost; do you agree?

Mr. UPTON. That is a very good point. I do agree.

Mr. WELLER. Well, thank you, Mr. Chairman. Fred, thanks for testifying.

Mr. UPTON. Thank you for your leadership. I just want to say that before the week is out I would like to think that we will get a lot more cosponsors on a bipartisan basis on this bill as well.

Chairman THOMAS. Does the gentlewoman from Ohio, Ms. Tubbs Jones, wish to inquire?

Ms. TUBBS JONES. Thank you, Mr. Chairman. I am going to take just a couple of minutes.

I want to applaud my colleague from Ohio, the Chair of the Housing and Community Empowerment Subcommittee of Financial Services. I used to serve on that Committee prior to coming to this Committee. You have said very clearly what I have been saying to just about every witness that has come in talking about dividend tax cuts, whether they knew anything about low-income, affordable housing or not. My purpose in doing that was to bring the issue to a higher level.

Mr. Ney, I just want to thank you for raising your concerns, because as the Chair of the Housing Subcommittee, the fact that you would raise these concerns, it will be given quite a bit of attention.

I just want to say also, this week—in fact, seated in the audience today—is a young woman from the Ohio Historic Preservation Committee, raising many of the issues; and I am sure that you will probably be visited today or tomorrow by those groups as well.

I just want to thank you for your leadership. It is always good to have a Buckeye that is doing a good job on housing.

Mr. NEY. Thank you, Mr. Chairman. Want to thank the gentlelady. We had a good year in Tempe, Arizona, too.

Mr. UPTON. Just wait till Ann Arbor this year.

Chairman THOMAS. I thank the gentlewoman. Any additional questions? The gentlewoman from Connecticut.

Mrs. JOHNSON OF CONNECTICUT. Thank you. I wanted to clarify from my colleague Mr. Upton what I believe is so, that your bill and my colleague Mr. Weller's bill allows expensing of all equipment.

Mr. UPTON. It does. You are right.

Mrs. JOHNSON OF CONNECTICUT. I am a cosponsor of that legislation, and I want to be sure that the record notes that by allowing immediate expensing for 18 months, which is something we can afford, we have a chance to help small manufacturing through a very, very difficult period created in very large part by government actions.

The steel decision is falling heavily on steel users. We are on the verge of losing a very critical component of our industrial base as a result of a public policy that imposed on them not only a 30 percent price increase, but unpredictable supplies and poor-quality supplies. So it has had a very heavy cost impact, sometimes as much as 50 percent on small manufacturers in New England at least; and this bill will help them to some extent get over that hump.

We also have allowed ourselves to manage a trade agreement with a formerly nonmarket economy with very little attention to the surge issues that we managed quite well in the 1980s and which, in the end, because we managed them, we enabled our machine tool industry to recapitalize itself, improve its technology, improve its productivity without being put out of business by the Japanese and the Taiwanese, who were able to produce machine tools with very different rules and access to capital.

So it is very important that we—that we pass this as part of any stimulus bill, because we really have to help the small manufacturers on whom ultimately our defense security does rest.

So I thank you for broadening your bill; and I thanked Mr. Weller before for his leadership on this issue. I think this is an extremely important issue, very relevant to the strength of our economy now and in the next few years. I look forward to working with you to get this as part of the stimulus package.

Mr. UPTON. I would just like to say, I know you know my district very well, as your mother used to live, when she was alive, in my district.

The steel decision, at the risk of offending my good friend, Mr. English, really hurt my district in a major way. We have so many small tool and die manufacturers and others that rely—the furniture industry, the appliance industry, the auto industry. That tariff decision was a death knell to many, many workers and this

is a way that we can begin to reverse that trend with that awful decision.

Chairman THOMAS. The Chairman notes that the gentleman from Michigan's comments have prompted another inquirer, and so the Chair, assuming there was one final one, now realizing there are three, would question the three who are interested if any of you have comments or questions to direct to the Chairman of House Administration, Mr. Ney, because his time is very constrained.

I believe the other two would be asking broader questions.

Does the gentleman from Wisconsin, Mr. Ryan, wish to——

Mr. RYAN. Yes, I do. Chairman Ney, I want to ask you a couple of questions, or actually bring something to your attention. Are you familiar with the new mortgage banker study about the low-income housing tax credit that came out?

Mr. NEY. Yes.

Mr. RYAN. Yes. It came out yesterday. I just wanted to make a couple of points.

Number one for the Committee, I think it is interesting to note that the econometrics firm that the MBA, the Mortgage Bankers, used to study the effects of the President's economic plan was Macroeconomic Advisors of St. Louis. This is the same macroeconomic forecasting firm that Bill Gale, the Brookings Institution economist, cited in his efforts to try to pan or trash the Administration's proposal.

What their econometrics model shows us is that the Bush plan will—within 18 months, by the end of 2004, create a million new jobs, will add 1.4 percent economic growth to GDP; that is from Macroeconomic Advisors that critics of the Bush plan have been using.

Chairman Ney, specifically, they actually analyze the effect this policy would have on the low-income housing tax credit, and they are not so sure that it would have an adverse effect. I just want to read something and then just bring it to your attention.

On the question of whether this has an adverse effect on the low-income housing tax credit they basically say, since dividend returns to shareholders are not negatively affected under any reasonable assumptions of dividend payout ratios, there appears to be no need to change the fundamental calculation of the excludable dividend amount, a policy advocated by the low-income housing tax credit associations. They said that because it appears that any potential negative effects would be due solely to the change in the capital gains basis and potential additional capital gains taxes, any remedy should be aimed at that issue. So the problem would be largely ameliorated by allowing the capital gains tax basis to be increased either by the amount of the low-income housing tax credit or by the amount of the low-income housing investment tax credit investments expensed by the investor, or lowering capital gains tax rates.

Do you know whether the low-income housing tax credit associations have looked at trying to find a fix on the capital gains basis side rather than trying to get the tax credit added back to the EDA?

Mr. NEY. Mr. Chairman, I believe they are looking at all options that protect, in fact, the ability for this program to continue.

I would note, I talked today to the mortgage bankers and just pointed out for them to take a second look, because this is so serious.

If I could, Mr. Chairman, I wanted to say something about the study. The premise of the study is, because the economic growth sparked by the President's proposal would increase corporate earnings, corporations that would have operated at a loss without the economic stimulation package will not sell their credits.

Now, the MBA study does not document its findings and is limited to a 2-year analysis, which is a very short period of time considering that the low-income housing tax credit program is a long-term program.

Second, the MBA study also doesn't quantify the price elasticity of the credit, even though it indicates the value of the credit will go down, if not for any other reason than effectively eliminating the double taxation of corporate earnings, increasing the cost basis of the stock.

Also, I want to point out, the MBA makes the argument, without the stimulus plan, without it, including the dividend exclusion component, the economy and the corporate earnings will go into such a tailspin that the demand for credits might be less than with the stimulus action. I don't think there is any reasonable expectation that would happen.

Lastly, if I could, the low-income housing tax credit program operates on slim margins with multiple layers of assistance. Even a small change in the value of the credit and reducing amount of equity capital raised within the credit program, which both the ENY and the MBA studies acknowledge would mean that the population location served by the program would probably change.

I wish I could answer the question better for the gentleman, but——

Mr. RYAN. I had a feeling you had an answer ready.

Mr. NEY. Right off the top of my head. I learned that from Mr. Thomas in House Administration over 6 years. I think that this needs to be really looked at is, I guess, the point of my answer.

Mr. RYAN. I just wanted to say, I am glad we are bringing this discussion to a really high level. The capital gains basis adjustment for the low-income housing tax credit is a new idea that I hadn't seen until I read this study. So I think that is something that is interesting to look at while we try and make sure that no damage is done to existing structures. So I appreciate that.

I also think it is important to note that macroeconomic forecasters at the Brookings Institution cite—to say it is a reason for opposing the Bush plan—tell us that we are going to get a million new jobs in the next year and half.

So, with that, I thank the Chairman.

Chairman THOMAS. I thank the gentleman. Does the gentleman from Pennsylvania still feel sufficiently motivated to inquire?

Mr. ENGLISH. I actually was hoping to allow this to go forward, but since a couple of policies have been mentioned that I am very directly interested in and my name has been invoked, I feel the need to make a couple of points.

First of all, I want to congratulate Mr. Upton for getting involved in the cause of promoting expensing. I have been involved in this

cause since 1996. I have introduced fundamental tax reform legislation to promote expensing. I agree with him that this is a fundamental reform that is necessary for us to maintain our manufacturing base on shore.

I have introduced my own bill to promote full expensing. I think my efforts complement his and Mr. Weller's, and I wish them well. I would encourage them to take a look at a couple of issues that are not addressed in their bill that are addressed in mine, for example, full retroactivity for 2003, which I think is essential if you are going to move an expensing bill forward.

Also, a better treatment of leasing products, I think is absolutely critical if you are actually going to move the language forward.

I think the principle that you have laid out here is a sound one, and I think it is absolutely critical for the cause of maintaining the level of capital investment necessary to keep good-paying jobs on shore. The only way our workers can compete with the Pacific Rim is if our employers are making the level of capital investment necessary in manufacturing facilities to be able to have—to continue to have the most productive workers on the planet here in the United States.

A couple of other points: I would simply commend the gentleman on the issue of tool and die and trade, on which I have spent a great deal of time. I would encourage him to look at the study done by the International Trade Commission, which frankly debunks the notion that steel prices are the primary problem for tool and die.

There are a variety of problems of which the brief spike in steel prices certainly was a contributing factor. Their real problems have to do with long-term moving of their customer base off shore and some other fundamentally difficult trade problems for which I don't think there is an easy remedy.

So I would welcome his participation. I don't think that really it serves much of a purpose to attribute all of the problems of small manufacturers to the President's steel policy which, after all, only covers 28 percent of the steel products being produced. We have seen a decline recently in steel prices, and also we have seen that steel prices are now higher in other jurisdictions than in ours.

I think that our steel consumers can thrive by using domestic steel and foreign steel where it is appropriate, but I don't think they need access to dump prices in order to be competitive, particularly given the way the international market is looking. You and I can disagree on that, but that is probably a topic for a different panel; and I salute you for the excellent work that you and Mr. Weller have done in looking at some of the tax issues that I think are central to maintaining our industrial base.

I thank the gentleman.

Mr. UPTON. I appreciate the gentleman's kind words and constructive comments, for sure. I also might add to that, maybe a Buy America provision with regard to expensing might be appropriate. I also want to thank the gentleman for his leadership on the tax credits for deploying broadband, something that we both care deeply about in urban and rural areas.

Chairman THOMAS. The Chair wants to thank all Members. Are there any additional inquiries or questions?

The Chair especially applauds those Members who have taken the time to examine additional ways in which we might assist the economy in this difficult time. I thank the gentleman from Michigan for his legislation and thank all Members. If there are no further inquiries, the hearing is adjourned.

[Whereupon, at 2:50 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of the Affordable Housing Tax Credit Coalition

Mr. Chairman and Members of the Committee, this statement is submitted by the Affordable Housing Tax Credit Coalition ("Coalition") in connection with the Committee's hearings on the Administration's proposals on economic growth included in the Fiscal Year 2004 budget. The Coalition is a trade organization based in Washington, DC, comprised of most of the major private sector participants in the Low-Income Housing Tax Credit ("Housing Credit") program. Its members represent syndicators, investors, for-profit and not-for-profit developers, lenders, managers and public agencies (including those which allocate Low-Income Housing Tax Credits). Coalition members are responsible for raising the vast majority of the Six Billion Dollars raised annually for investment in affordable rental housing properties. We appreciate this opportunity to share our views with the Committee.

Introduction

The Coalition wishes to stress that it takes no position on the overall dividend exclusion proposal. Indeed, some of the Coalition's members have expressed support for the Administration's proposal. Our concern is strictly with the impact of this proposal on the ability of the Housing Credit to produce the affordable housing that Congress intended in enacting this program.

If enacted in its present form, the Administration's proposal to eliminate double taxation of corporate dividends could have a severely adverse impact on the Housing Credit program, the only significant producer of affordable rental housing for America's low-income families. Without the rental housing that the Housing Credit provides, America's housing crisis will worsen significantly and the major economic stimulus the Housing Credit provides will be lost. Although we do not believe the Administration intends to undermine the Housing Credit or the low-income housing opportunities it provides, this proposal puts the Housing Credit's future in serious jeopardy.

Background of the Housing Credit

Originally signed into law as part of the Tax Reform Act of 1986, the Housing Credit is responsible for the production of virtually all affordable rental housing in the United States—over 115,000 dwelling units annually and 1.5 million units since enactment. The Congress understood from the beginning that private capital would be attracted to affordable housing *only* in exchange for tax credits since cash returns would be virtually non-existent as a result of rental restrictions. The program is a model of well-thought-out good government, involving effective public-private partnerships and sound administration by the States, which together assure the housing is developed and maintained according to strict program rules. Its longevity is testimony to the fact that the program has operated as intended. The program enjoys widespread and bipartisan congressional support—in 2000, legislation to increase the amount of Housing Credits was co-sponsored by *85% of the Congress*, with almost equal numbers of Republicans and Democrats.

How the Housing Credit Works

The program provides tax incentives, in the form of credits against federal income tax, in exchange for investment in newly constructed or substantially rehabilitated affordable rental housing. For periods of 30 years or more, this housing serves low-income people, who pay restricted rents and who earn a maximum of 60% of area median income (although average incomes in these properties are far lower). Credits are allocated to the States based upon population. The States determine, within broad federal guidelines, their own housing priorities and then choose the properties which are to be awarded Housing Credits. Developers, many of which are non-profit organizations, compete for Housing Credits; in most States demand for Housing Credits far exceeds the supply, even with the recent increase authorized in 2000. Developments which are awarded Housing Credits are located in urban, suburban

and rural areas. Although a majority of the properties serve families, a substantial number serve elderly, disabled and special needs populations.

Once the Housing Credits are awarded, investors provide equity capital to finance a substantial portion of the costs of constructing or rehabilitating the housing. This equity capital reduces the need for mortgage financing and decreases debt service payments, thereby lowering operating cost and allowing owners to rent to low-income persons who pay regulated rents well below market rates.

Approximately 98 percent of this equity capital is raised from corporations, including banks, financial institutions, insurance companies, and Government Sponsored Enterprises such as Fannie Mae and Freddie Mac. Investors have contributed *Forty Billion Dollars* since 1986. Due to passive loss and alternative minimum tax limits, individual investors supply very little capital and cannot compensate for any reduction in corporate investment. Even if the passive loss and alternative minimum tax rules were to be substantially modified, raising capital from individual investors is far less efficient because individuals cannot be expected to make commitments at the levels which corporations invest, which are typically in the tens of millions of dollars.

It is important to note that the prices which corporations are willing to pay for Housing Credits have risen dramatically over the past ten years, which translates into more equity available to build affordable housing. Prices began to rise after the Congress made the Housing Credit program a permanent part of the Internal Revenue Code in 1993 because investors became confident that the program would be around for the long term. Indeed, prices have risen by approximately 50 percent in the past ten years, meaning that the program's efficiency has increased tremendously over that time.

Housing Credits are earned over a 10-year period, although they are subject to recapture for 15 years if various program rules are violated. Accordingly, corporations are highly motivated to make sure that the Housing Credits are received and not lost to recapture. Many corporations engage firms with special expertise in this area, often referred to as Housing Credit syndicators, to help them in structuring and monitoring the properties. This very intense oversight and the effective administration conducted by States are the principal reasons that the program has operated in accordance with government requirements—and even exceeded expectations—throughout its history.

Impact of the Dividend Exclusion Proposal on the Housing Credit

Dividends paid by corporations to individual shareholders would be excluded from taxable income when paid out of *previously taxed corporate income*. Dividends paid by corporations in excess of previously taxed income would be included in taxable income. The proposal is intended to provide the exclusion only if the corporation has paid tax on its earnings to avoid double taxation on the earnings. However, to the extent that a corporation reduces its corporate tax burden by the receipt of Housing Credits (as well as most other tax credits), it lowers the amount of tax-free dividends it can distribute to its shareholders (or "deemed dividends" that shareholders can use to increase their stock basis for capital gains purposes). An exception is provided under the proposal for foreign tax credits. We understand that an exception will also be provided for alternative minimum tax credits.

The Committee has been presented with the Ernst & Young LLP report entitled, "The Impact of the Dividend Exclusion Proposal on the Production of Affordable Housing" (the "E&Y Report"). The E&Y Report was commissioned by the National Council of State Housing Agencies. The E&Y Report makes a compelling case that if the proposal is enacted, there will be reduction of approximately 40,000 dwelling units each year—or 35 percent of Housing Credit production. This will adversely affect more 80,000 people annually. Extrapolated over the next ten years, this proposal could mean that over 800,000 people will be deprived of the decent, safe and affordable housing that the Housing Credit provides.

It is important to recognize, as does the E&Y Report, that each corporation will be affected differently by the dividend exclusion proposal and that corporate decision making with respect to Housing Credit investments may vary widely from company to company. In our view, the most dramatic impact may be to drive down the price that corporations are willing to pay for Housing Credits. As demonstrated by the E&Y Report, on average, a corporation which today pays approximately 92 cents for each dollar of Housing Credit will find that the loss of shareholder tax benefits can be greater than the net benefits at the corporate level (See, Exhibit I–1 and page 5 of the E&Y Report). The result is that investment in Housing Credits may be unattractive at current prices.

To the extent that some corporations will be willing to pay less for Housing Credits, it will inevitably affect what all corporations are willing to pay because is axio-

matic that prices are determined by the marginal buyer. If prices paid for Housing Credits drop, it will mean that there will be less equity capital available for the production of affordable housing.

As shown in the E&Y Report, affordable housing properties are financed principally from three sources—first mortgage financing, whose debt service must be paid from property revenues; "soft" financing, typically obtained from state and local governmental sources, where repayment terms are deferred and payable only from available cash flow; and from equity capital. The amount of first mortgage financing is tied to the rental revenues of the property and since rents are strictly limited under the Housing Credit program, that financing is not able to be increased if other sources are decreased. The amount of equity capital is tied principally to the amount of Housing Credits generated by a particular project (which, in turn, is tied to the costs incurred) and to the amount an investor is willing to pay for a given amount of Housing Credits. Theoretically, the reduction in equity capital could be made up by an increase in soft financing, but that is highly unlikely in light of budget constraints faced by all levels of government. Even if the costs of the housing could be reduced, which may or may not be possible, the amount of equity capital would be further reduced because the amount of Housing Credits generated is a function, in part, of the costs to produce the housing.

The result is if there is less equity, then there will be a financing gap which will make a substantial number of affordable housing developments financially infeasible. In other words, the sources available will be less than the costs of building the housing. In Ernst and Young's estimation, this means that 40,000 fewer units can be produced.

The mere introduction of this proposal has caused some corporations to suspend making Housing Credit investments. Accordingly, it is critical that the Administration and the Congress act expeditiously to protect the Housing Credit program so that investments are not frozen and production of affordable housing is not crippled.

The Housing Credit Provides Economic Stimulus

More and more working families need affordable housing. Today, 40 million Americans—one in seven—either spend more than one-half their income on housing or live in substandard conditions. This problem has increased by an alarming 60% between 1997 and 2001. The Congressionally-appointed, bipartisan Millennial Housing Commission stated last year that the evidence is "mounting that stable, affordable rental housing plays an important role in helping families find and hold jobs."

The dividend exclusion proposal is part of a larger package introduced by the Administration in the hopes of reviving our weak economy. However, it would be tragic and ironic if this economic stimulus proposal undermined the Housing Credit program, which itself serves as a powerful economic stimulus. Based on figures extrapolated from a study conducted by the National Association of Home Builders, each year the construction and ongoing operation of Housing Credit properties generates approximately $8.8 billion of income for the economy, creates 167,000 jobs, and produces $1.35 billion of revenue for cash strapped local governments.

In short, harming the Housing Credit harms the economy.

Proposed Solution

To prevent a short-term cessation or a decrease in investment in Housing Credit properties, the Administration and the Congressional leadership should immediately issue statements that the Housing Credit program will be protected in the dividend exclusion proposal. The solution should be to allow income, the tax on which has been offset by the Housing Credit, to be included in a corporation's excluded dividend account, thereby allowing corporations to distribute such dividends tax-free to shareholders or to allow the same basis adjustments as would be otherwise permitted under the proposal. This solution would simply allow the continued success of the Housing Credit program and the ongoing production of critically needed affordable rental housing for low-income persons.

We understand that concern has been raised that if relief is provided for the Housing Credit, then advocates for other credits and tax preferences will seek similar treatment. While we are not opposed to treating other credits in a like manner, our principal concern involves the Housing Credit. The Congress has historically singled out the production of affordable housing for special treatment. In 1986, despite the dramatic changes which affected most taxpayers, the Congress and Administration recognized the need to continue to provide incentives for affordable housing and it created the Housing Credit program in response. In 1993, the Congress made the Housing Credit permanent, singling it out among a number of other credit programs. As noted earlier, the Administration has determined already to treat foreign

tax credits and alternative minimum tax credits in a manner similar to our proposal. The point is that logical distinctions can and should be made and we urge the Committee to do so in the case of this very valuable and successful program.

Statement of the Alliance for Small Business Investment in Technology, Arlington, Virginia

The Alliance for Small Business Investment in Technology (ASBIT)—a coalition of small business trade associations and computer industry corporations—is a strong supporter of the provision to increase expensing to $75,000 in the President's economic growth package. ASBIT very much supports the Small Business Expensing Improvement Act of 2003 and the many other elements of the package that will pave the way for economic growth.

Currently small businesses may expense up to $25,000 in capital expenditures each year, which is well below the annual technology investments of many small businesses, especially for a small capital intensive manufacturing company such as a commercial printer. Computer equipment makes up about 33% of the total amount of capital equipment expensed under section 179. The technological advances over the last two decades have greatly enhanced the productivity of small businesses. In fact, a recent Department of Labor report stated that American productivity has nearly doubled since 1995—from 1.4% to 2.6% annually—largely as a result of advancements in technology. Furthermore, many economists agree that higher worker productivity contributes to sustained economic growth; leads to lower unemployment and can grow government tax revenues. Some estimates show that a one-half-point increase in worker productivity could add close to $1 trillion to the US tax coffers. Therefore, the need for increased expensing is certainly greater than it has ever been considering the current state of our economy.

Provisions increasing expensing limits passed the House and the Senate last year with bipartisan support. The President's proposal to increase current expensing limits to $75,000 with a $325,000 phase out, embodied in H.R. 179, introduced by Representatives Herger, Weller, Johnson of Connecticut, Crane, Lewis of Kentucky, Foley, and Manzullo, and S. 158, introduced by Senators Snowe and Bond, will help businesses and the economy even more. We are very grateful to the President for proposing and to these legislators for introducing legislation to implement the change.

While there are some signs of a possible weak economic recovery, the need to increase small business expensing allowances would further strengthen the economy by giving small businesses the opportunity to grow. Small businesses are increasingly dependent on current IT tools to stay competitive and we need these tools now in order to create jobs and assure recovery from the recession.

This legislation will help the nation's nearly 20 million small businesses and especially the nearly 100,000 small technology and small manufacturing companies that have been especially hard-hit in the recent economic downturn. We urge the Ways and Means Committee to support for this beneficial update in U.S. tax law.

About ASBIT

The Alliance for Small Business Investment in Technology (ASBIT) is a bipartisan coalition of small business and information technology trade associations and companies that supports federal tax law changes to promote small business investment in technology products and services. ASBIT believes that such changes will improve small business productivity and strengthen the U.S. economy and the IT sector.

Members of ASBIT include:

AeA (American Electronics Association)
Business Software Alliance
Career College Association
Circuit City
Computers for Schools
CompTIA (Computing Technology Industry Association)
Corning, Incorporated
Gateway
Information Technology Association of America
Information Technology Industry Council
Intel Corporation
National Association for the Self-Employed
National Association of Women Business Owners
National Small Business United
National Society of Accountants
National Tooling & Machining Association
Printing Industries of America
Radio Shack
Small Business Council of America
Small Business Survival Committee

Statement of the American Forest & Paper Association

Executive Summary

AF&PA Strongly Supports The President's Proposal To Eliminate The Double Taxation Of Corporate Income because it will improve the competitive position of U.S. industry and result in job creation and economic growth.

U.S. Tax System Less Competitive

In 1998, PricewaterhouseCoopers undertook a study for AF&PA to determine how income taxes in the U.S. compare with income taxes in six other countries in terms of facilitating or inhibiting investments in paper manufacturing and forestry. The study was updated in 2001 and again in 2003. Companies in the other countries, Brazil, Canada, Finland, Germany, Indonesia and Japan, compete aggressively with U.S. companies in all aspects of the forest products industry.

The result was that U.S. income taxes are the most unfavorable of all the competing nations, or very close to it, for corporate income from papermaking and forestry. Moreover, because of recently enacted tax law changes by some competing countries, the U.S. will be even less tax competitive by 2005. In short, U.S. tax rules consistently raise disadvantages for U.S. corporate investments relative to the tax rules in most of the industry's competing nations. The overall effect is that U.S. companies cannot undertake certain investments that foreign competitors can undertake profitably because U.S. investors would be left with too little after paying tax. Because U.S. companies compete against foreign companies in capital and product markets both at home and abroad, the U.S. tax disadvantage ultimately limits the degree to which U.S. companies may successfully challenge foreign competitors.

The reason that the U.S. tax system imposes such high effective tax rates compared to the competing nations is that the U.S. has high tax rates on every major piece of an investment—corporate-level earnings and individual-level earnings of interest, dividends and capital gains. In particular, the U.S. has the highest tax rate on the dividend income of individuals, net of any dividend credit. The range is zero (Brazil and Finland) to 43.8 percent (U.S.). See Attached Exhibits.

The effective tax rate on U.S. corporate forestry operations is the highest of all nations studied—53 percent. This rate is 22 percentage points higher than the average of the other competing countries. See **Exhibit 2**. For paper manufacturing, the comparable effective tax rate is 61 percent—13 percentage points higher than the average of our international competitors. See **Exhibit 1**. As previously cited, one of the major reasons for this disparity is the fact that the U.S. has the highest effective tax rate on dividend income among forest products industry trading partners. Enactment of the President's proposal to eliminate the double taxation of corporate income would go a long ways towards helping the competitive position of the U.S. forest products industry.

Effect Of The Dividend Proposal

Specifically, enactment of the Administration's proposal to eliminate the double taxation of corporate income would reduce the U.S. effective tax rate on paper manufacturing from 61 percent to 44 percent. This would place the U.S. in the middle of the competing nations in terms of tax competitiveness. If the Administration's proposed reduction of individual income tax rates were also enacted, the effective tax rate on U.S. paper manufacturing investments would decline further, to 40 percent. See **Exhibit 1**.

Likewise, the effective tax rate on corporate forestry would decline from 53 percent to 34 percent, moving the U.S. into the middle of the group of competing nations with respect to these investments. The U.S. effective tax rate would decline to 29 percent if the proposed individual income tax rate reduction is adopted. See **Exhibit 2**.

Reforestation Tax Act

The aforementioned PricewaterhouseCoopers study also showed that the U.S. provides worse tax treatment than all our competitors do for reforestation costs and for the sale of timber. Congress can go a long way toward improving this situation by enacting "The Reforestation Tax Act" (RTA), which will soon be reintroduced this Congress by Rep. Jennifer Dunn and Rep. Max Sandlin, members of this Committee. Last Congress, the RTA (H.R. 1581) had 111 bipartisan cosponsors, including 21 current members of this Committee, whom we hope will be original cosponsors of the reintroduced RTA.

The RTA does two things to remove disincentives for private investment in our forests and promote reforestation efforts: (1) reduces the tax paid on timber sold by individuals and corporations; (2) improves the tax treatment of reforestation expenses.

It is enthusiastically endorsed by all elements of the forest products industry—individual landowners, large and medium sized forest and paper companies and our labor unions. In addition, the RTA has the support of environmental groups such as the Conservation Fund, since the bill directly encourages replanting resulting in not only reduced sprawl but also an improved environment due to trees storing carbon dioxide that would otherwise be released into the atmosphere.

Conclusion

Enactment of the President's dividend proposal and the Reforestation Tax Act will make U.S. forest products companies competitive with our primary international competitor countries. The net effect of these policy changes will ensure that U.S. companies continue to be the dominate player in the world market for paper and wood products. Absent these changes in the tax law, this industry will decline in importance to the U.S. economy and to the many communities that rely on the industry for employment opportunities and tax revenue.

The American Forest & Paper Association appreciates the opportunity to provide data that underscore the importance of the President's proposal to eliminate the double taxation of corporate income to the competitiveness of U.S. industry and job creation. We strongly support enactment of the President's proposal and look forward to working with the Committee on Ways and Means to ensure that U.S. manufacturers have a tax code that enables them to compete in a world economy. The elimination of double taxation of corporate income is one of the most important steps the committee can take to accomplish this shared goal.

AF&PA is the national trade association representing more than 240 member companies and related associations that engage in or represent the manufacturers of pulp, paper, paperboard and wood products, as well as the growers and harvesters of this nation's forest resources. America's forest and paper industry ranges from state-of-the-art paper mills to small, family-owned sawmills and some 9 million individual woodlot owners.

The U.S. forest products industry is vital to the nation's economy, providing approximately 7 percent of the U.S. manufacturing output, while ranking among the top ten manufacturing employers in 42 states. More than 1.5 million people are employed by the forest products industry with an estimated annual payroll of $64 billion. Sales of the paper and forest products industry top $250 billion annually in the U.S. and export markets, making us the world's largest producer of forest products. We are also a natural resource based industry responsible for planting, growing and harvesting trees, a basic renewable resource.

Despite these impressive numbers, all is not well with the forest products industry. We face serious international competitive threats. New capacity growth is taking place in other countries, where forestry, labor and environmental practices are not always as responsible as those in the U.S. Failure to successfully address the competitive challenges facing our industry means that public demand for our products will increasingly be met by other nations who do not adhere to our high standards. Without our influence as a major international market presence, the ability of the U.S. to advance responsible forestry standards and forest product manufacturing practices globally would be compromised. The decline of the domestic industry is causing serious economic harm for many communities across the country where the industry is a way of life. This is reflected in the fact that since 1997, 88 U.S. paper mills have closed. In the last two years alone, 40 mills have permanently shut their doors, idling 104 machines and about 6 million tons of productive capacity. As a result, the industry has lost more than 43,500 jobs, or 19 percent of our workforce, in the last 5 years.

Recognizing the danger posed by our industry's loss of competitiveness, in 1998 AF&PA undertook an extensive research project to identify the causes of this trend and determine what could be done to maintain the domestic industry's viability. The results of this research made it clear that the major factors causing erosion of our competitive position are:

- Reduced Access to Fiber
- Environmental Regulation
- International Trade Barriers
- U.S. Tax System

It is the last factor where this Committee has jurisdiction and can make a meaningful difference in the competitiveness of U.S. industry.

U.S. Tax System Less Competitive

In 1998, PricewaterhouseCoopers undertook a study for AF&PA to determine how income taxes in the U.S. compare with income taxes in six other countries in terms of facilitating or inhibiting investments in paper manufacturing and forestry. The study was updated in 2001 and again in 2003. Companies in the other countries, Brazil, Canada, Finland, Germany, Indonesia and Japan, compete aggressively with U.S. companies in all aspects of the forest products industry. To the best of our knowledge, no other industry has undertaken such a comprehensive study to see exactly how U.S. tax law compares to that of our competitors.

The result was that U.S. income taxes are the most unfavorable of all the competing nations, or very close to it, for corporate income from papermaking and forestry. Moreover, because of recently enacted tax law changes by some competing countries, the U.S. will be even less tax competitive by 2005. In short, U.S. tax rules consistently raise disadvantages for U.S. corporate investments relative to the tax rules in most of the industry's competing nations. The overall effect is that U.S. companies cannot undertake certain investments that foreign competitors can undertake profitably because U.S. investors would be left with too little after paying tax. Because U.S. companies compete against foreign companies in capital and product markets both at home and abroad, the U.S. tax disadvantage ultimately limits the degree to which U.S. companies may successfully challenge foreign competitors.

The Rankings

The rankings of competing nations from least taxed to most taxed are subsequently displayed in the attached charts. See **Exhibits 1 & 2**. The rankings refer to income taxes levied on corporate income, first the tax paid by the corporation and second the tax paid by shareholders and lenders as a result of their financing the investments that generated the corporate income.

In general, the U.S. and Canada have the least competitive income taxes, while Indonesia, Brazil, Finland and Japan have the most competitive income tax systems. Germany is now closer to the less competitive pair, but by 2005 will be among the more competitive group.

Why the U.S. Tax System Is Not Competitive

The reason that the U.S. tax system imposes such high effective tax rates compared to the competing nations is that the U.S. has high tax rates on every major piece of an investment—corporate-level earnings and individual-level earnings of interest, dividends and capital gains. In particular:

- The U.S. has the highest tax rate on the dividend income of individuals, net of any dividend credit. The range is zero (Brazil and Finland) to 43.8 percent (U.S.).

- The U.S. has the second highest tax rate on corporate income. The range is 29 percent (Finland) to 43.7 percent (Japan). The U.S. is at 39.2 percent.
- The U.S. has the highest tax rate on the capital gain income of individuals. The range is zero (Germany) to 24.2 percent (U.S.).
- The U.S. has the third highest tax rate on the interest income of individuals. The range is 15 percent (Indonesia) to 51.2 percent (Germany). The U.S. is at 43.8 percent.

Integration of Income Taxes

If a country that has both a corporate income tax and an individual income tax does not integrate the two taxes, then income generated by corporate investments will be exposed to two income taxes while income generated by noncorporate businesses bears just one level of income tax. In an unintegrated system, such as in the U.S., corporate shareholders first pay the corporate income tax and then pay individual income tax on (i) dividends that the corporation pays out or (ii) capital gain on increased stock values due to the earnings that the company retains.

Countries use different methods to mitigate or eliminate double taxation of corporate income. A shareholder might be allowed to deduct dividends received for the reason that that income has already been taxed once under the corporate income tax. Under a more elaborate and theoretically precise approach (called the imputation credit), a shareholder may be given a credit to reduce individual income tax by the amount of corporate income tax imputed to his shares and then be taxed on the corresponding amount of the corporation's earnings under the individual income tax.

The U.S. does not integrate its corporate and individual income taxes. Most countries in the competing group provide a significant degree of integration to relieve the double taxation of corporate income.

President's proposal to Eliminate the Double Taxation of Corporate Income

The President's proposal would integrate corporate and individual income taxes so that corporate income would be taxed once and only once. Under the proposal, corporations would be permitted to distribute nontaxable dividends to their shareholders to the extent that those dividends are paid out of income previously taxed at the corporate level. The effective tax rate on U.S. corporate forestry operations is the highest of all nations studied—53 percent. This rate is 22 percentage points higher than the average of the other competing countries. See **Exhibit 2**. For paper manufacturing, the comparable effective tax rate is 61 percent—13 percentage points higher than the average of our international competitors. See **Exhibit 1**. As previously cited, one of the major reasons for this disparity is the fact that the U.S. has the highest effective tax rate on dividend income among forest products industry trading partners. Enactment of the President's proposal to eliminate the double taxation of corporate income would go a long ways towards helping the competitive position of the U.S. forest products industry.

Specifically, enactment of the Administration's proposal to eliminate the double taxation of corporate income would reduce the U.S. effective tax rate on paper manufacturing from 61 percent to 44 percent. This would place the U.S. in the middle of the competing nations in terms of tax competitiveness. If the Administration's proposed reduction of individual income tax rates were also enacted, the effective tax rate on U.S. paper manufacturing investments would decline further, to 40 percent. See **Exhibit 1**.

Likewise, the effective tax rate on corporate forestry would decline from 53 percent to 34 percent, moving the U.S. into the middle of the group of competing nations with respect to these investments. The U.S. effective tax rate would decline to 29 percent if the proposed individual income tax rate reduction is adopted. See **Exhibit 2**.

According to a study prepared for the Business Roundtable, the Administration's economic growth plan will increase the number of U.S. jobs beyond the current forecast by an average of 1.8 million per year for the next two years and an average of 1.2 million per year for the next five years. The dividend component will have the single most positive effect on growth, alone accounting for an average of 500,000 jobs per year for the next five years. This is critical for the forest products industry given the previously referenced mill closures and job losses the industry has suffered in the previous five years.

The double tax on corporate income increases the cost of capital for corporations. According to the President's Council of Economic Advisors, enactment of the President's economic growth plan would reduce the cost of capital by more than 10 percent. This reduction will encourage higher levels of corporate investment and capital accumulation, resulting in greater productivity increases and, therefore, higher

wages for workers. Productivity improvements are essential to job and wage growth in manufacturing sectors such as forest products. I urge the Committee to support the President's bold initiative to eliminate the double taxation of corporate income.

Reforestation Tax Act

Another reason the U.S. tax code is not competitive with competing nations is the tax treatment of forestry operations. No other competitor country imposes such a large percentage of tax on corporate forestry operations. In addition to industry competitiveness, there are environmental reasons and reasons relating to urban sprawl why the U.S. should provide better tax treatment for forestry operations.

The 2001 Southern Forest Resource Assessment (SFRA) study by the U.S. Forest Service examined the status, trends and potential future of southern forests. It concluded tax policy is an important component in keeping land in forest cover. Urban growth presents a substantial threat to the condition, health and long-term sustainability of these forests. Between 1982 and 1997, developed land in the South increased by 45 percent, representing 12 million acres of forest lost forever to development. The SFRA report concluded that another 12 million acres could be sold and developed by 2020. Specifically, there are two critical ways the tax code can play a role in keeping land in working forests that AF&PA urges the Committee to consider. They include changing how reforestation costs are treated under the tax code and the tax treatment of the gain from the sale of timber.

AF&PA agrees with the SFRA conclusion that changes to the tax code are needed to ensure that landowners hold on to their forest land rather than be forced to sell to developers, thus worsening urban sprawl. Another reason for providing tax incentives for owners of timber is competitiveness. The aforementioned PricewaterhouseCoopers study also showed that the U.S. provides worse tax treatment than all our competitors do for reforestation costs and for the sale of timber.

We do not believe this situation was intended by Congress. Rather it is more likely the result of years of tax policy changes without an analysis of the accumulated effect on either urban sprawl or international competitiveness. Unfortunately, current law discourages job creation in the U.S., promotes imports and undercuts the high environmental standards that the U.S. practices. Congress can go a long way toward improving this situation by enacting "The Reforestation Tax Act" (RTA), which will soon be reintroduced this Congress by Rep. Jennifer Dunn and Rep. Max Sandlin, members of this Committee. Last Congress, the RTA (H.R. 1581) had 111 bipartisan cosponsors, including 21 current members of this Committee, whom we hope will be original cosponsors of the reintroduced RTA.

The RTA recognizes the unique nature of timber and the overwhelming risks associated with an investment in this essential natural asset and attempts to place the industry in a more equal position with its international competitors. Trees can take anywhere from 25 to 75 years to grow to maturity. Fire, disease, weather, events that are unpredictable and uninsurable, can wipe out acres of trees at any time during the long, risky growing period. Good management practices can help mitigate some of nature's vagaries, but are costly over the entire growing period. The RTA does two things to remove disincentives for private investment in our forests and promote reforestation efforts: (1) reduces the tax paid on timber sold by individuals and corporations; (2) improves the tax treatment of reforestation expenses.

Specifically, the RTA provides a sliding scale reduction in the amount of taxable gain based on the number of years the asset is held—3 percent per year, up to a maximum reduction of 50 percent. While this provision does not fully compensate for the negative tax impact of inflation, it does provide a significant incentive for landowners not only to re-plant their land after a timber harvest, but to keep their land in forest cover for generations to come.

Under current law, the first $10,000 of reforestation expenses are eligible for a 10 percent tax credit and can be amortized over 7 years. Reforestation expenses are the initial expenses required to establish a new stand of trees, including expenses for site preparation, the cost of seedlings and the labor costs required to plant the seedlings. Because amounts over $10,000 may not be amortized and do not qualify for the credit, most reforestation expenses are not recoverable until the timber is harvested, many years after being incurred. The revised RTA removes the $10,000 cap and allows all reforestation expenses to be expensed in the year incurred. This change in the law will provide a strong incentive for increased reforestation by eliminating the arbitrary cap on such expenses and allowing them to be immediately expensed.

The RTA is enthusiastically endorsed by all elements of the forest products industry—individual landowners, large and medium sized forest and paper companies and our labor unions. In addition, the RTA has the support of environmental groups such as the Conservation Fund, since the bill directly encourages replanting result-

ing in not only reduced sprawl but also an improved environment due to trees storing carbon dioxide that would otherwise be released into the atmosphere. Last year, the RTA was one of a number of bills subject to a hearing on Environmental/Conservation Tax Measures before Chairman Jim McCrery's Select Revenue Measures Subcommittee. When asked to comment on the bill, the entire panel of witnesses, representing industry, environmental and conservation groups all expressed support for the bill.

A variation of the RTA was included in the 1999 Omnibus Tax Bill that passed Congress but, for unrelated reasons, was vetoed by President Clinton. Likewise, it was included in the Minimum Wage and Small Business Tax Relief Bill passed by the House in 2000.

AF&PA strongly urges the Committee to include the RTA in tax legislation you enact this year. The RTA has the benefit of being bipartisan, helps our industry's competitive position, helps U.S. companies and the jobs they provide and promotes sustainable forestry in an environmental friendly way.

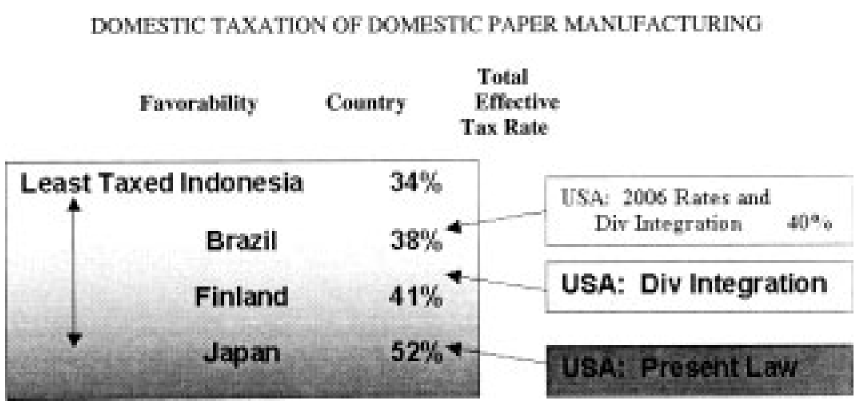
Conclusion

Enactment of the President's dividend proposal and the Reforestation Tax Act will make U.S. forest products companies competitive with our primary international competitor countries. The net effect of these policy changes will ensure that U.S. companies continue to be the dominate player in the world market for paper and wood products. Absent these changes in the tax law, this industry will decline in importance to the U.S. economy and to the many communities that rely on the industry for employment opportunities and tax revenue.

PricewaterhouseCoopers

Exhibit 1

ISSUE: Where are the tax hurdles the highest for a corporation that would invest in papermaking it its own country?



CONCLUSION: The U.S. tax system raises very high hurdles compared to other countries. The effective tax rate of the United States is the second highest in the competing group and 13 percentage points higher than the average for other countries.

PricewaterhouseCoopers

Exhibit 2

ISSUE: Where are the tax hurdles the highest for a corporation that would invest in forestry and timber in its own country?

CONCLUSION: The U.S. tax system raises very high hurdles compared to other countries. The effective tax rate of the United States is the second highest in the competing group and 22 percentage points higher than the average for other countries.

Statement of the American Gas Association

Executive Summary

- The American Gas Association represents the nation's local natural gas utilities. Natural gas companies are traditional utilities with relatively stable income streams.
- Natural gas utilities pay out nearly two-thirds of their net income to their five million shareholders.
- Natural gas utility shareholders are both older and less affluent than shareholders at large. Eliminating the double taxation of corporate dividends will be of enormous benefit to them.
- Repealing the double tax upon dividends will greatly assist natural gas utilities in raising the $100 billion in capital that they will need in the next two decades to fund the infrastructure that the growing natural gas market will demand.
- Sound national policy should encourage this growth, because natural gas is an abundant domestic energy resource, it is an economical fuel, and it is the most environmentally benign of the fossil fuels.

Introduction

The American Gas Association ("AGA") is grateful for the opportunity to share its views with the House Committee on Ways and Means with respect to the issue of eliminating the double taxation of dividends. AGA is composed of 190 natural gas distribution companies that deliver natural gas throughout the United States. Local gas utilities deliver gas to more than 64 million customers nationwide, and AGA members deliver approximately 83 percent of this gas.

Energy utilities that deliver natural gas have approximately 5 million shareholders. Their market capitalization is nearly $300 billion. They contribute about $15 billion in dividends to the economy annually.

AGA member companies are, and always have been, traditional "brick and mortar" enterprises. They acquire natural gas supply on behalf of most of their customers, who are principally residential and commercial consumers. They deliver this gas through more than one million miles of underground pipe. While many AGA members provide other (usually related) services to their customers, the traditional gas acquisition and delivery function is at the core of their business. State public service commissions typically regulate the rates and terms and conditions of service of AGA members under traditional cost-of-service regulation.

AGA members are utilities in the well-known, traditional sense of the word. From a financial perspective, AGA members enjoy a relatively steady pattern of net income. As a result, almost all AGA member companies pay regular dividends to their shareholders. Natural gas distribution utilities pay out nearly two-thirds of their net income in dividends, almost twice the average for U.S. public companies. Indeed, many AGA member companies have paid quarterly dividends without interruption for decades (in some cases, even longer). As a whole natural gas utilities have a dividend yield of approximately five percent annually.

The shareholder profile of AGA member companies is, as will be discussed below, unique. Quite importantly, the shareholder base of natural gas utility companies is very heavily tilted toward those who purchase shares and hold them, principally for the steady and significant dividend flow that they produce.

AGA enthusiastically supports the proposal to eliminate the double taxation of corporate profits (first on corporate income and then again upon shareholder income) by excluding dividend income from a shareholder's taxable income. Doing so will provide enormous benefit to the shareholders of AGA member companies, will enhance their disposable income, and, will provide an economic impetus for the economy. It also will enhance the ability of AGA member companies to raise capital in order to build the $100 billion of new infrastructure that the market will demand in the two decades ahead. In the discussion that follows, we will explain why AGA member companies endorse this proposal with such enthusiasm and why adopting the proposal would serve the national interest.

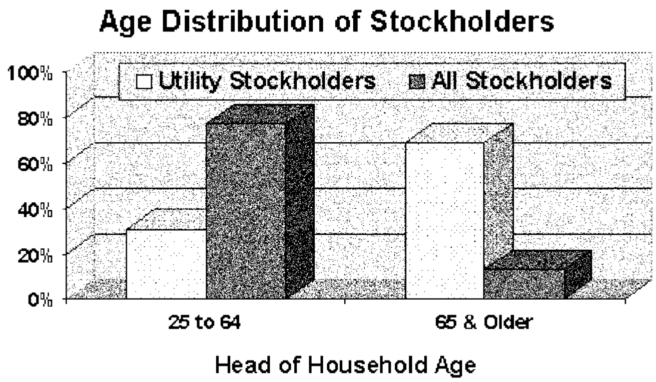
There are many sound reasons to eliminate the double taxation of dividends. Two reasons are most pertinent to natural gas utilities. *First*, elimination of the double taxation of dividends will be strongly beneficial to the unique shareholder base of natural gas utilities. *Second*, elimination of the double taxation of dividends will markedly improve the ability of natural gas utilities to raise the $100 billion in capital that they will require in the next two decades to provide the clean burning, economical natural gas that America's consumers will demand.

Natural Gas Utility Shareholders Will Be Particularly Benefited By Elimination Of The Double Taxation of Dividends

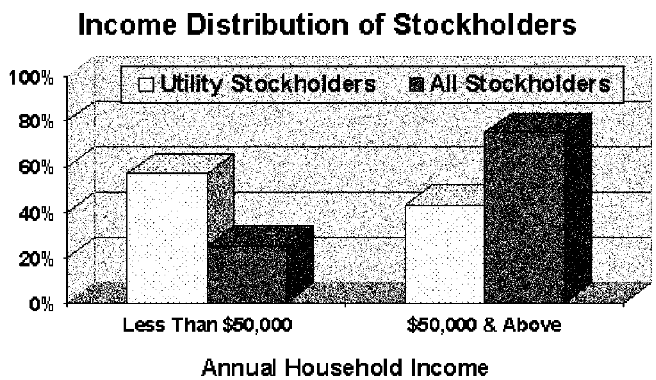
Utility stocks have historically attracted investors that seek the stable income and regular dividend stream that regulated utilities produce. These investors tend to be older (perhaps retired) and less affluent than shareholders as a group. They also tend to rely upon the regular income stream that utility stocks produce. Utility stocks appeal to those investors that do not have the risk tolerance that is necessary for investments in more speculative or volatile stock issues, where returns are often in the form of capital gains at some uncertain, future date. In times past, the prototypical utility shareholder was the retired investor with significant holdings in one or more telephone or electric companies. (That picture may have changed somewhat when the telephone business became the telecommunications industry and when some electric utilities became merchant generators and traders. As those industries now return to basics, they may again attract their historical shareholder group.)

This traditional picture of a utility investor, however, continues to exist today for natural gas utilities. Individual investors hold more than *half* of the outstanding shares of gas distribution companies.[i] Now, as in the past, gas utility investors are individuals who are *older and less affluent than investors at large*. Nearly 70 percent of utility stockholders are 65 years of age or older, compared to 22 percent for all stockholders. This fact is amply demonstrated by the following graphic:

[i] Survey of American Gas Association members, 2002



Moreover, almost 60 percent of utility shareholders have annual household incomes less than $50,000, compared to 25 percent for all stockholders as a group:[ii]



The present proposal for tax reform would, therefore, be of direct and significant assistance to natural gas utility shareholders. *First,* removing the double taxation of corporate dividends would be of measurable benefit to the many natural gas utility shareholders who depend on dividends for their retirement income. Removing the double tax would increase the disposable income of these retirees. *Second*, doing so would be of great benefit to those at large who are not in the upper income brackets. It would directly reduce their tax burden and would increase their disposable incomes. Moreover, there is a greater likelihood that lower-income and middle-income shareholders will spend their cash dividends rather than save them, thus promoting further near-term growth in the economy.

Natural Gas Utilities Rely Upon The Distribution Of Dividends As An Important Means Of Attracting Investment Capital

According to an Edward Jones survey,[iii] investors choose utility stocks first for income and dividends and then for the security and stability of the underlying stock. In order to provide these distributions, gas utilities use most of their corporate net income to fund dividends—on average, gas distribution utilities distribute 62 per-

[ii] Edward Jones, *Utility Investor Survey 2000* and the Federal Reserve Board, *Survey of Consumer Finances 1998.*

[iii] Edward Jones, *Utility Investor Survey 2000*

cent of their net income to investors as dividends,[iv] compared to 33 percent for the S&P 500 index.[v]

Given the important role of dividends in attracting capital to the utility sector, elimination of the double taxation of dividends would provide a unique benefit to natural gas utilities. The result would be a significant boost in the dividend cash stream to investors. This would provide an additional, and important, incentive for investors to invest in natural gas utilities, thus encouraging long-term capital formation by not penalizing investment in companies, such as gas utilities, that pay a large portion of their net income in dividends. Unfortunately, current law penalizes dividends as a means of attracting capital. Doing so is unsound economic and tax policy.

This tax reform would encourage companies to pay dividends rather than spending their funds on stock buy-back programs or investing in the securities of other companies. Such actions can be viewed as unproductive from an economic perspective. As the following discussion will demonstrate, elimination of the double taxation of dividends will provide an important and appropriate incentive that is in the national interest.

Consumers today are turning to natural gas because it is a domestic energy source, because it is a good fuel value, and because it is the most environmentally friendly fossil fuel. The U.S. Department of Energy expects natural gas consumption to grow about 50 percent in the next 20 years.[vi] To meet this demand, natural gas utilities will need to spend $100 billion by 2020 to build new distribution pipeline infrastructure.[vii] (This does not include normal investment in replacement, maintenance, and safety of distribution facilities). Moreover, security-related investments have become more critical since 9/11. Natural gas utilities are working with the Federal Government to ensure the continued safe and reliable delivery of natural gas, even in today's uncertain environment. In any event, all commentators agree that the natural gas market is to grow by approximately 50 percent in the next twenty years. Enormous new investment will be necessary to meet this demand growth.

It is in the national interest that the market demand for natural gas be met. Natural gas is a domestic fuel. Production of natural gas stimulates the economy, avoids deleterious balance-of-payments issues, and promotes the security of the nation. It is best for the nation that we rely upon domestic energy sources because the investment in production (and jobs) occurs in the United States, the payment for the production does not go to a foreign source, and no foreign power may, at will, interdict the delivery of the commodity. Moreover, natural gas is relatively benign from an environmental perspective. America's natural gas utilities have an outstanding record for providing an economic fuel source safely, reliably and securely. AGA believes that national policy should, where possible, assist in facilitating this growth in the market. Elimination of the double taxation of dividends will clearly do so. It will reinforce the attractiveness to shareholders of utilities as an investment. It will, therefore, assist natural gas utilities in raising the $100 billion in capital that will be required to meet the projected demand for natural gas.

Elimination of The Double Taxation of Dividends Will Stimulate Economic Growth

Eliminating the double taxation of dividends would increase the disposable income of stockholders, thereby stimulating consumer spending and the economy as a whole. This multiplier effect would be more significant with regard to natural gas utilities than with other companies, as utilities distribute more than 60 percent of their net income as dividends and their shareholders tend to be older and less affluent.

The Double Taxation Of Dividends Is Inequitable To Corporation and Taxpayers

Under existing tax law, corporations distribute dividends employing funds that have already been subjected to the corporate income tax—most often at the 35 percent rate. The dividend is then taxed *again* to the individual taxpayer recipient at his or her marginal tax rate, which can be as high as 38.6 percent. The top marginal rate for individuals is nearly twicethe rate paid on capital gains, which is the other component of shareholder return. Existing law unfairly penalizes the payment of

[iv] Data from Research Insight/PC Plus Data November 2002 and CA Turner Utility Reports December & January Issues 2002

[v] Wall Street Journal, *Will Stock Dividends Get Back Their Respect?* December 10, 2002

[vi] U.S. Department of Energy, Energy Information Administration, *Annual Energy Outlook 2003*. Numerous other analysts are fundamentally in agreement with these projections.

[vii] American Gas Foundation, *Fueling the Future,* 2000

dividends by taxing them twice, at a cumulative tax burden that usually exceeds 50 percent. This is inequitable to both the corporation and to its individual shareholders. Moreover, it unfairly taxes dividends when compared to other returns. Capital gains carry no tax at the corporate level, and they are taxed at less than half the effective rate of dividends at the shareholder level. And returns on debt instruments—interest on corporate debt—are free of tax at the corporate level.

Elimination Of the Double Taxation Of Dividends Would Promote Efficient Entity Selection And The Efficient Allocation Of Capital

Current law promotes inefficiency in capital markets in at least two ways. As noted above, dividends are treated unfairly when compared to capital gains and returns on debt. Moreover, they are treated unfairly when compared to returns from other forms of business entities. Under current law, returns on capital invested in general partnerships, limited partnerships, joint ventures, and limited liability companies are only taxed once. Indeed, an extremely large number of such entities exist solely for the relatively favored tax treatment that they enjoy. Repealing the double taxation of corporate dividends would, therefore, promote efficiency in the selection of business entity. The needs of the markets—capital and consumer—would dictate the form of entity rather than the tax code.

Moreover, double taxation of dividends artificially skews corporate investment decisions toward debt. Interest payments to bondholders and note holders are *deductible* at the corporate level, while dividends are *taxed twice*. Returns on debt and on equity should receive comparable tax treatment so that the market can determine whether debt or equity is the appropriate investment instrument in any particular circumstance.

Elimination Of the Double Taxation Of Dividends Will Encourage Sound Corporate Management

Under the corporate laws of most states, dividends may only be paid from earnings or capital surplus. In practical terms, dividends almost always are paid from current earnings. An entity that pays dividends, therefore, must have both earnings and cash in order to do so.

Over the last two years, the nation has witnessed an array of stunning corporate failures, including a wide array of improper accounting *legerdemain*, outright fraud and illegality, and abuses by corporate managers and directors. Eliminating the double taxation of dividends will rectify the current disfavored treatment of dividends. It also will likely lead to an increased demand by shareholders for the payment of dividends. This will translate into an economic incentive for managers to operate their businesses in such a fashion that they can pay dividends. In correlative fashion, corporate managements will be required to focus on succeeding the old fashioned way—by generating corporate earnings. Given the events of the last several years, this is sound policy that Congress should seek to encourage.

Repealing the double taxation of corporate dividends would represent a major change in U.S. tax policy. It would have a material and significant affect on the financial planning strategies of U.S. companies as well as a major impact upon future entity-formation decisions. For these and other reasons it would be prudent, as is the case with many major shifts in tax policy, that appropriate transition rules be incorporated in the legislation implementing the change.

Statement of the American Insurance Association

The American Insurance Association (AIA) appreciates having this opportunity to submit testimony on the President's dividend exclusion proposal ("Proposal"). AIA supports eliminating the double taxation of corporate earnings. We applaud the President's bold initiative to eliminate tax code biases that influence decisions about corporate and shareholder investment. We are concerned, however, that the treatment of tax-exempt bonds issued by state and local governments ("municipal bonds") would drive-up borrowing costs for state and local governments, inhibit property and casualty (P&C) insurer participation in the municipal bond market and reduce the values of current P&C insurer investment portfolios. In AIA's view, these adverse effects can be avoided—by treating the implicit tax paid on a municipal bond investment as a tax paid for purposes of the excludable dividend amount (EDA) and the retained earnings basis adjustment (REBA)—in a manner that is consistent with the President's goals, Treasury's prior analysis of this issue, and current tax law principles.

AIA's over 400 P&C insurance company members together wrote some $98 billion in P&C insurance premiums, or almost 30% of the P&C insurance market, in 2001. As of 2000, the P&C insurance industry held over $180 billion in municipal bonds. These holdings comprised over 10% of total outstanding such bonds, roughly 20% of total P&C insurance industry assets, and 50% of municipal bond holdings in the corporate sector in that year. Because municipal bonds offer needed security, liquidity and attractive after-tax yields, many AIA members invest significant amounts of their portfolios in these bonds in order to back obligations to pay insured losses to policyholders (e.g., in the event of a natural disaster or other catastrophic event). P&C insurers, among the largest institutional investors in intermediate and longer-term maturity municipal bonds, help to maintain stable and reasonable borrowing costs for state and local governments.

The Administration proposes to eliminate the adverse effects of the double taxation of corporate earnings by making distributions of previously-taxed corporate earnings nontaxable to shareholders. After studying integration of the corporate and individual income tax systems for a full year, Treasury concluded in 1992 that such nontaxable treatment should apply to dividends paid out of earnings from investments in municipal bonds.[1] For unexplained reasons, however, Treasury now proposes to abandon this conclusion.

The Proposal would include in a corporate investor's EDA its after-tax yield on a taxable bond, but would exclude from EDA the yield on a municipal bond. The EDA is the account out of which a corporation may make distributions to its shareholders without additional shareholder-level tax. Excluding the yield on a municipal bond, which is implicitly taxed to the investor, would penalize corporate investment in such bonds.

The holder of a municipal bond gives up yield in lieu of paying federal income tax. The spread between taxable and municipal bond yields represents the implicit tax incurred by the municipal bond holder.[2] The economic result is the same as if the holder had purchased a higher-yielding, taxable corporate bond, with the Federal Government then remitting the difference in yields to state and local governments. Unless the implicit tax is taken into account in calculating EDA, P&C insurers either will shift their investments to taxable bonds or demand a higher return on municipal bonds, thereby decreasing demand for municipal bonds and increasing the cost of borrowing for state and local governments. Simply put, the Federal Government would collect more tax from the P&C insurer at the expense of state and local governments.

Leaving municipal bonds taxed (implicitly) at the corporate level and (explicitly) at the shareholder level would perpetuate distortions that arise from the multiple taxation of corporate earnings. It also would have the perverse effect of treating the implicit tax paid by an investor to U.S. state and local governments less favorably, in terms of EDA, than the tax paid by the same investor to foreign countries. Thus, the Proposal is intended to "integrate the corporate and individual income taxes so that corporate earnings generally will be taxed once and only once."[3] Consistent with this intent, the Proposal provides that corporate income subject to tax paid to a foreign sovereign and sheltered from U.S. income tax by the foreign tax credit, should not be taxed again when it is distributed to the corporation's shareholders.[4] Under the Proposal, however, corporate municipal income, which is subject to implicit tax paid to a U.S. sub-national sovereign, would be taxed again when it is distributed to the corporation's shareholders.

Treating the implicit tax paid to state and local governments when a corporate investor purchases a municipal bond less favorably, for purposes of calculating the EDA, than the tax paid by that same investor to a foreign country (which is included in the EDA), would have the following adverse effects:

- ***Investments in Municipal Bonds.*** The exclusion of municipal bond interest from EDA would make corporate municipal bond investment less attractive (relative to current law and also relative to a taxable bond). Loss of corporate demand would increase municipal bond yields, increase borrowing costs to state

[1] *A Recommendation for Integration of the Individual and Corporate Tax Systems* at 2, 4–6 (Department of the Treasury, December 1992).

[2] "Holders of tax-exempt investments accept a lower rate of return in exchange for the exemption from income tax obligations on the investment received. The difference between the taxable and tax-exempt rates may be viewed as an implicit tax which is 'paid' to State and local government issuers." *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens* (Joint Committee on Taxation, June 14, 1993).

[3] *General Explanation of the Administration's Fiscal Year 2004 Revenue Proposals* at 12 (February 2003).

[4] The Proposal provides for the "flow-through" to shareholders of the foreign tax credit.

and local governments at a time when they can least afford it, and immediately depress the value of current corporate municipal bond holdings, impairing the liquidity of any P&C insurers needing to sell such bonds to pay losses.

- ***Investment in P&C insurers.*** Shareholders can be expected to prefer investment in corporations that can make excludable dividends out of EDA. The exclusion from EDA of earnings from municipal bonds would deter investment in corporate purchasers of such bonds, leaving P&C insurers that invest heavily in municipal bonds at a distinct disadvantage in attracting investor interest in the marketplace.[5]
- ***Equity.*** The exclusion from EDA of earnings from municipal bonds would cause a P&C insurer's purchase of a municipal bond to create tax liability at the shareholder level. No shareholder-level tax would apply if the same bond is purchased by a shareholder (or if a taxable bond is purchased by a P&C insurer).
- ***Purpose of Proposal.*** The key purpose of the dividend exclusion proposal is to mitigate economic distortions arising from the double taxation of corporate earnings. By leaving municipal bonds taxed (implicitly) at the corporate level and (explicitly) at the shareholder level, the Proposal would perpetuate these distortions.

AIA has been asked whether transitional relief for holders of municipal bonds (i.e., "grandfathering" of bonds issued as of a fixed date) would resolve the problems. Congress provided transitional relief for municipal bonds held by P&C insurers when the "proration" rules were adopted as part of the Tax Reform Act of 1986.[6] Similar transitional rules were provided in the 1986 Act for municipal bonds held by banks. While such relief would avoid frustrating the reasonable, past investment expectations of corporate investors in municipal bonds, however, it would do nothing to address the market disincentives or increased costs of borrowing for state and local governments that arise under the Proposal.

To eliminate the adverse impacts of the Proposal on P&C insurers and the municipal bond market, AIA respectfully urges you to amend the Proposal to allow for the addition to EDA of interest on municipal bonds (as an approximation of the implicit tax that is paid on such bonds).[7]

Statement of ASPA, Arlington, Virginia

Introduction

Thank you for this opportunity to submit ASPA's views on the impact of Treasury's proposal to eliminate the double taxation of corporate earnings contained in H.R. 2, the Jobs and Growth Act of 2003. ASPA is a national organization of over 5,000 retirement plan professionals who assist hundreds of thousands of small businesses throughout the country in establishing and maintaining qualified retirement plans for their workers.

We would like to begin by thanking the members of the Ways and Means Committee for their efforts over the last decade to improve the retirement security of our nation's workers. In particular, we greatly appreciate the efforts of Chairman Thomas, and Representatives Portman, Cardin, Pomeroy, and others for their emphasis on expanding the retirement plan coverage rates of our nation's small business workers, which have lagged behind the coverage rates of workers at larger firms.

The critical role of employer-sponsored plans in promoting savings by American workers cannot be understated. According to the Employee Benefit Research Institute, middle-income workers are more than 10 times as likely to save if they are covered by a workplace retirement plan than on their own. Further, workplace retirement plans have made middle income Americans owners in the stock market. According to the Investment Company Institute, almost half of the over 50 million

[5] "While it is difficult to say exactly to what extent dividend taxes are reflected in share prices, research generally finds evidence consistent with the view that at least a portion of the shareholder level taxes on dividends are capitalized into share prices. That is, elimination of the dividend tax increases the after-tax value of dividends and, thus, the price investors are willing to pay for corporate equities." *Eliminating the Double Tax on Corporate Income* at 4 (Council of Economic Advisers, January 7, 2003).

[6] Under the proration rules in section 832(b)(5)(B) of the Internal Revenue Code of 1986, P&C insurers today are taxed on municipal bond interest at an effective tax rate of 5.25%.

[7] This would apply to the portion of a P&C insurer's municipal bond interest earnings (85%) that is not subject to proration.

American households that own stock first purchased stock through a workplace retirement plan. Noting that 79 percent of equity owners participate in employer-sponsored plans, the president of the Securities Industry Association recently emphasized, in a 2002 press release, "the important role that employer-sponsored retirement plans play in introducing Americans to investing."

The Administration began 2003 by unveiling an almost $700 billion stimulus package intended to jump-start the economy. The centerpiece of this package is a proposal that would generally exclude from shareholders' taxable income corporate dividends that have already been taxed. Specifically, under the Administration's proposal, all dividends that are paid out of corporate earnings that have already been fully taxed at the corporate level would be excludable from the income of the shareholder who receives them. Alternatively, the proposal provides that if the company retains already fully taxed earnings, the shareholder will be entitled to a basis adjustment to reflect the already fully taxed retained earnings. However, the proposal specifically does not apply to stock held in tax-favored retirement vehicles such as qualified retirement plans and IRAs.

In a general sense, the tax effect of the Administration's proposal is similar to the operation of a Roth IRA. Amounts are invested on an after-tax basis and earnings (already taxed at the corporate level) are tax-free. However, unlike a Roth IRA, there are no limits on the amounts that can be invested nor are there any restrictions or penalties on early distributions. Consequently, questions have been raised about the potential impact of the Administration's proposal on retirement savings, particularly savings by workers of our nations' small businesses. While the Administration's proposal may arguably address reasonably sound tax policy concerns about making sure that corporate income is taxed only once, it potentially could have an unintended, adverse impact on small business retirement plan coverage.

Impact on Retirement Savings Generally

Since the proposal was announced, the Administration has been arguing that the dividend exclusion proposal does not disfavor retirement savings. The basis for their argument is that a deductible IRA and a Roth IRA are economically neutral, assuming the same tax rates at the time of contribution and distribution. For example, assume a $1,000 contribution to a deductible IRA and a 5 percent rate of return. If it were withdrawn one year later, assuming a 40 percent tax rate and ignoring early withdrawal penalties, the taxpayer would net $630. If, instead, the same taxpayer contributed to a Roth IRA, the contribution would be $600. Assuming everything else is the same, after the first year, the taxpayer would again net $630. Given this economic neutrality, the Administration argues that because their proposal has a similar tax effect as the Roth IRA, it is at most equally neutral as compared with a deductible tax-favored retirement savings vehicle. In the Administration's view, tax-favored retirement savings vehicles remain more attractive because they inherently have more investment flexibility.

Contrasting views have been expressed suggesting that if the Administration's proposal were enacted the investment community would most certainly develop competitive products to take advantage of the new law. Further, unlike retirement savings vehicles, the investments made under the President's proposal would be advantaged since they would not be subject to limits or restrictions, or penalties upon early distribution. Regardless of which of these views seems more persuasive, though, one thing is clear—the relative value of tax-favored retirement savings vehicles would be somewhat lessened if the Administration's proposal were enacted.

Effect on Small Business Retirement Plan Coverage

For many small business owners, the decision to establish a qualified retirement plan is particularly sensitive to the value of the tax incentives provided through qualified plan rules. There is no question that the law provides qualified plans with valuable tax incentives—contributions to the plan are tax-deductible and earnings are tax-deferred until distributed. However, qualified plans are also subject to stringent nondiscrimination and top-heavy rules that require small business owners to make contributions on behalf of their employees in order to make contributions on behalf of themselves. Given the valuable tax incentives accorded qualified plans, Congress determined it appropriate to impose these nondiscrimination requirements in order to provide rank-and-file workers with a fair share of retirement benefits.

Due to these nondiscrimination rules, for every dollar a small business owner wants to contribute to a qualified plan on his or her own behalf, he or she will generally have to spend a minimum of 30 to 40 cents on behalf of employees. This expenditure represents a combination of the implementation and administrative costs associated with a qualified plan, and the cost of covering the business' workers—

a prerequisite to the owner's participation in the plan as required by the qualified plan nondiscrimination rules.

Given this added cost, the relative value of the tax incentives provided under the qualified plan rules is a critical element to the small business owner's decision to establish a retirement plan. Consequently, if a small business owner were able to save an equivalent amount outside of a qualified pension plan in a tax-favored alternative without such added cost, such an alternative would significantly reduce the incentive of the small business owner to incur the responsibilities of contributing to a retirement plan for the small business' workers. An unlimited, uncapped exclusion from taxable income of qualifying dividends (and undistributed after-tax earnings) is just such an attractive alternative. Such a non-plan alternative is made even more attractive when you consider that there are no restrictions on distributions and early-withdrawal penalties as there are with a plan. Further, by not establishing a workplace retirement plan the small business owner could avoid exposure to potential fiduciary liability that he or she would otherwise be subject to with such a plan.

If the Administration's proposal were enacted in its current form, it would not be difficult for the small business owner to generate tax-free investment returns that would be more financially advantageous than investing in a qualified retirement plan. For example, if the Administration's proposal had been effective over the last 15 years, based on our analysis, a simple investment in an S&P 500 index fund would generate on average approximately a 5 percent tax-free annual yield. For many small business owners, during this period they would have been significantly better off investing under the Administration's proposal than through a qualified retirement plan. In effect, from the perspective of the small business owner, the Administration's proposal turns the tax-advantaged qualified retirement plan into a tax-*disadvantaged* plan.

For example, consider a small business with one owner and 5 employees. The owner would like to save the maximum each year to a defined contribution plan—currently $40,000. In order to do that, the qualified plan nondiscrimination rules would require the owner to make roughly $13,000 in contributions on behalf of employees, a cost of 32.5 percent. If the small business owner had invested her annual $40,000 contribution over the last 15 years in an S&P 500 index fund, the owner would have accumulated after-tax savings of $504,482, assuming a 40 percent tax rate.

Assume instead that the Administration's proposal had been in place over the last 15 years. If the small business owner took the combined $53,000—the $40,000 for herself and the $13,000 for the employees—and gave herself an annual bonus and invested the after-tax amount (approximately $32,000 assuming a 40 percent tax rate) over the same 15-year period in an S&P 500 index fund, the owner would have accumulated after-tax savings of *$641,884*, over $137,000 more than with the qualified retirement plan, due to the power of the tax free dividends and appreciation under the Administration's proposal. In the real world, a decision to save 21 percent less for retirement is not one many small business owners will make.

The Administration's decision to extend the dividend exclusion proposal to variable annuities makes it even more likely that a small business owner will forego adopting a plan in favor of saving on his or her own. In the above example, the small business owner could take her after-tax bonus and invest it annually in a variable annuity. A variable annuity operates just like a 401(k) plan by offering multiple investment choices and allowing investments to be diversified without current tax consequence. Further, like a 401(k) plan, a variable annuity is only taxed when distributed. However, unlike a 401(k) plan, it is not subject to any limits or nondiscrimination rules. Now, under the Administration's proposal, a substantial portion of the earnings under the variable annuity will be tax free. Thus, by extending the proposal to variable annuities, the Administration not only makes it more financially advantageous for the small business owner to save without a plan, but it also provides the small business owner with the same ability to diversify investments as if the owner had a plan.

In light of this, a significant number of small business owners will likely choose the non-plan option consistent with the Administration's proposal and avoid the necessity of making contributions on behalf of their small business employees. They may offer their employees a 401(k) plan, but such a plan would be funded solely with contributions made by the small business employees with no contributions, like matching contributions, made by the owners, likely reducing the participation rates of many small business workers.

Critics of this view suggest that there are other reasons besides tax incentives for a small business owner to establish a plan, such as the need to compete for employees, which will lead to small business retirement plan coverage. However, ASPA

members who work closely with America's small businesses every day know that the incremental decision to establish a workplace retirement plan by the owner of a small business, which has been operating quite well without a plan, has little to do with competition for employees. Surveys conducted by Employee Benefit Research Institute show that employees of small businesses without a plan would generally prefer wages instead of retirement plan coverage. Thus, the tax incentive carrot to the small business owner is needed in order to bring the small business workers into the savings game.

Tax and Social Policy Concerns

ASPA recognizes the tax policy arguments underlying the proposition that income should be taxed only once. However, ASPA also joins the Administration and the Congress in its firm support for the *social policy* underlying incentives to encourage businesses—and particularly small businesses—to establish and fund qualified retirement savings plans for the workers employed by our nation's small businesses. Ironically, thanks to the tremendous efforts of the Ways and Means Committee significant progress has been made. According to the Congressional Research Service, since 1996 coverage of full-time small business employees at firms with less than 25 employees has increased from 25 to over 33 percent. This translates to millions of small business workers who now are covered by a plan.

Unfortunately, unless the Administration's proposal is modified to include workplace retirement plans, just as was done for variable annuities, the tax policy that supports tax-free qualifying dividends will likely undercut the good social tax policy that incents small business owners to provide retirement coverage for their workers. Failure to modify the proposal that would exclude qualifying dividends from taxable income (or increase basis to reflect after-tax retained earnings) could make the employees of our country's small businesses potential losers.

It is a heavy price to pay for theoretically sound tax policy.

Statement of the Edison Electric Institute

The Edison Electric Institute (EEI) is pleased to provide comments for the record on the Committee on House Ways and Means' hearing on March 6, 2003. EEI is the association of U.S. shareholder-owned electric companies, international affiliates, and industry associates worldwide. Our U.S. members serve over 90 percent of all customers served by the shareholder-owned segment of the industry. They generate approximately three-quarters of all the electricity generated by electric companies in the U.S. and service about 70 percent of all ultimate customers in the nation.

EEI would like to thank the Chairman and this Committee for holding this important hearing on the Administration's proposal to eliminate the double taxation of corporate dividends. This statement is intended to demonstrate the reasons for our strong commitment to this important tax law change.

We believe the double taxation of corporate dividends is fundamentally unfair and is bad tax policy. This statement outlines the reasons why EEI believes Congress should act quickly to eliminate the double taxation of corporate dividends. It also addresses several transition and implementation issues within the Administration's proposal that are of concern to us. We recommend that these issues be addressed and changes made in order to make the proposal more equitable.

THERE ARE MANY BENEFITS TO BE GAINED FROM ELIMINATING THE DOUBLE TAXATION OF CORPORATE DIVIDENDS.

Eliminating the Double Taxation of Corporate Dividends Would Increase the Spending Power of the Millions of Americans Who Own Shares in Public Companies, Including Electric Utility Companies.

Today, 84 million Americans—or over 50 percent of American households—own shares in public companies. Eliminating the double taxation of corporate dividends would offer these investors more incentives to diversify their stock portfolios, which is widely recognized as the healthiest long-term investment strategy.

Eliminating the double taxation of corporate dividends would be particularly beneficial to the nearly 4 million individual shareholders who own shares in our nation's electric companies. These companies have a long history of paying dividends, and the industry maintains the highest payout ratio of dividends when compared to other major sectors.

In 2001,[1] shareholder-owned electric companies paid $12.7 billion in common-stock dividends. Based upon the industry's consolidated financial statements, this group paid out an average of 58 percent of their earnings in dividends. For the twelve months ending September 30, 2002, total dividends paid escalated to $13.7 billion.

Based on their dividend-paying record and their stock appreciation, electric utility companies traditionally have been viewed as a stable and secure investment with a reasonable rate of return.

According to a Salmon Smith Barney report entitled "Eliminating the Double Dip," under a most likely scenario, eliminating the double taxation of corporate dividends is worth approximately $2 per share for each $1 of dividend paid. This equates to an additional 10 percent appreciation potential for the typical electric company stock.

Eliminating the Double Taxation of Corporate Dividends Would be Particularly Important for Older Americans—Many of Whom Own Shares in Electric Utility Companies.

According to the American Association of Retired Persons (AARP), seniors received nearly half of the $147 billion in taxable dividend income in 2000. Seniors depend heavily on dividend checks to supplement their retirement income and to help them pay for their day-to-day living expenses.

Electric utility company stocks have always been an attractive option for older Americans, who value these stocks for their dividends, security, and reliable performance. Based on demographic data gathered by EEI for our 2001 Financial Review, U.S. electric company common shareholders are likely to be:

- Over 65 years of age (70 percent)
- A resident of the United States
- A person that holds their stock for more than nine years
- Split 50/50 by gender

Dividends make up a larger percentage of seniors' income than capital gains, wages, and other non-Social Security income. Eliminating the double taxation of corporate dividends would provide an average tax savings of $936 for the 9.8 million seniors receiving dividends.

Eliminating the Double Taxation of Corporate Dividends Would Benefit Out Nation's Economy by Giving Investors More Available Income to Either Spend in the Economy or to Reinvest in the Market.

Eliminating the double taxation of corporate dividends would benefit the U.S. economy and taxpayers across the income spectrum, both of which will boost investor confidence.

Under current law, the double taxation of dividends: 1) encourages an over reliance on debt rather than equity financing; 2) encourages management to retain cash inside the company; and 3) discourages dividend payouts. These actions penalize growth, and serious economic distortions occur when companies essentially are encouraged to borrow and retain earnings rather than paying them out to shareholders.

Americans have been losing faith in the economy and stock market. However, millions of Americans depend on the market and their investments for their savings and retirement plans. The paying of dividends requires companies to have cash in order to make the payouts. Consumers trust a dividend check. Eliminating the double taxation of dividends will encourage more investors to return to the stock market, thereby creating a positive environment for higher rates of investment that will boost long-term growth and productivity.

Eliminating the Double Taxation of Corporate Dividends Would Benefit Out Nation's Electricity Infrastructure and It's Customers by Drawing Investors Back to the Power Sector.

The electric utility industry is now facing some of the most significant financial challenges ever. In fact:

- Between December 2000 and December 2002, shareholder-owned electric utility companies lost $78.3 billion in market capitalization, a 23.9 percent drop over

[1] 2001 is the last year for which data are currently available.

two years.[2] The EEI Index, a measure of the overall stock performance of electric utilities, was down by 14.7 percent in 2002.

- Throughout 2002, credit rating changes in the power sector also were overwhelmingly negative. According to Standard & Poor's (S&P), the ratio of downgrades-to-upgrades rose 12:1 as of December 2002, up from a 3:1 ratio in 1999, 2000, and 2001. Downgrades outnumbered upgrades 81 to 29 in 2001 and 182 to 15 in 2002. The percentage of companies on "negative watch" rose to 25 percent in 2002.

Today, electric utilities are taking aggressive steps to rebuild their balance sheets and promote greater transparency in electric power markets in order to restore investor confidence. They are selling non-core assets, downsizing, issuing new equity, canceling acquisitions, reducing significant levels of capital expenditures, realigning trading around their own generation assets and customer obligations, and accelerating debt repayment. EEI is leading an aggressive action plan for the electric industry that embraces vastly greater transparency in financial disclosure and corporate governance implementation.

For the electric power industry—one of the most capital-intensive industries in the world—the erosion of investor confidence has had a devastating impact on companies' access to capital on reasonable terms. The higher cost of capital makes it more difficult to fund badly needed infrastructure projects to maintain reliable electric service and to meet growing demand.

Eliminating the double taxation of corporate dividends would benefit electric companies by:

- Encouraging electric utilities—like other public companies—to pay increased attention to their dividend programs as a way to enhance their ability to attract capital through equity rather than debt. Equity is considered financially superior and less risky than debt. If equity financing were more attractive, companies would be able to strengthen their balance sheets with leaner debt/equity ratios.
- Helping them address their critical infrastructure needs. If more individual investors are brought back to the sector, electric companies would have better opportunities to enhance infrastructure systems—electric transmission and distribution lines, natural gas pipelines, and power plants—needed to maintain system reliability and to meet the growing demand for electricity.
- Restoring investor confidence and increasing the overall flow of cash into electric utilities and ultimately to their shareholders. The cost of equity capital will be reduced as the investor's rate of return is enhanced.

The proposed elimination of double taxation has already drawn attention to electric utility stocks. In fact, integrated electric utility stocks were up an average of 7.0 percent for the first month following the announcement of the dividend proposal.

TRANSITION/IMPLEMENTATION ISSUES NEED TO BE ADDRESSED TO MAKE THE PROPOSAL MORE EQUITABLE.

I. Changes Made to the Dividend Proposal Prior to Introduction of H.R. 2

- **Corporate Alternative Minimum Tax (AMT)**

We want to commend the Chairman of the Committee on Ways and Means for recognizing that pre-2001 AMT credits should not reduce the excludable dividend account (EDA) balance. Such credits constitute a pre-payment of tax and fall within the Administration's objective of "taxes fully paid."

- **EDA Carryovers**

Again, we want to commend the Chairman for recognizing the strong pro growth effects of permitting EDA carryforwards. While we agree that granting the Department of Treasury the ability to regulate in this area (as set forth in H.R. 2) is a step in the right direction, we would argue a statutory solution is preferable. EDA carryforwards will significantly promote economic growth and should be approved as a legislative amendment during Committee markup.

II. "Smoothing" Mechanism Needed for Disparate Income Years

As introduced, H.R. 2 assumes a 2003 date of enactment for the dividend proposal, with a two-year "look-back" to 2001 for establishing the baseline year. Our concern with this proposal is simple—2001 was an uncharacteristically poor economic year for our industry. The economic recession and September 11, as well as electric utility industry restructuring at the state level, combined to create an indus-

[2] This is based upon the stock performance of 65 shareholder-owned electric companies. If one expands the coverage to include unregulated utilities, the drop in market cap is even steeper.

try-wide reduction in revenues. This resulted in an abnormally low amount of taxes paid for 2001. (Traditionally, our industry pays one of the highest effective tax rates of any industry.)

The dividend proposal relies on a "taxes paid" calculation for determining the amount of dollars available in the EDA. The requirement to use 2001 as the baseline year dramatically alters the EDA calculation for most of our members and results in a serious detriment to our shareholders. The rationale for putting forth the dividend proposal is to stimulate the economy. The arbitrary assignment of 2001 as the baseline year results in a dramatically reduced stimulative effect for our industry.

Since 2001 was a poor economic year for many industries, a generally applicable transition rule for establishing the EDA baseline should be included during Ways and Means Committee markup. Specifically, a transition rule should allow a taxpayer to elect to calculate EDA based on either the federal taxes paid for the applicable year or through the use of a "smoothing" mechanism to account for disparate income years.

III. Transition Relief for Investments Already Made

Congress has traditionally used the Internal Revenue Code (IRC) to encourage economic behavior. By providing tax incentives for activities such as renewable energy (IRC Sec. 45) and non-conventional fuels (IRC Sec. 29), our industry has been encouraged to pursue these public policy objectives. To date, the shareholder-owned electric power industry has invested large sums of money to promote these congressionally authorized objectives.

It seems incongruous that Congress is now considering diminishing the value of these incentives by reducing the EDA in the dividend proposal. This seems particularly unfair since companies have already made investments based on these tax incentives. We believe this action will set a bad precedent and will make it more difficult for Congress to encourage economic behavior in the future.

For investments already made, we believe that transition relief in the form of "grandfathering" should be included during Committee markup for investments already committed. Credits (whether based on investment or production), which are attributable to investments already made, should not be an offset in calculating EDA.

CONCLUSION

Eliminating the double taxation of corporate dividends is extremely important to the millions of Americans who own stock in U.S. companies, to our nation's seniors, to the U.S. economy, and to America's shareholder-owned electric utility companies and their shareholders.

The times has come to stop the unfair double taxation of corporate dividends. EEI strongly urges Congress to act now.

Statement of F. Barton Harvey, III, Enterprise Foundation, Columbia, Maryland

Introduction and Overview

The Enterprise Foundation appreciates the opportunity to comment for the printed record of the Committee's hearing on the president's economic growth proposals. Enterprise is a national nonprofit organization that supports community- and faith-based organizations and their neighborhood revitalization initiatives. In our 20 years we have invested more than $4 billion, which has helped finance more than 144,000 homes for low-income families and strengthen hundreds of community-based organizations nationwide. We are currently investing more than half-a-billion dollars annually into grassroots groups and distressed communities all across the country.

In our public policy advocacy, Enterprise works on a bipartisan basis to advance policies that will help low-income people and places join the economic mainstream. We are proud to be a leading participant in the Administration's campaign to increase minority homeownership. We were honored that President Bush mentioned our contributions in both his major public speeches on that important initiative. We are strong supporters of the Administration's proposed Homeownership Tax Credit, enactment of which would help boost minority homeownership significantly.

Enterprise does not oppose or endorse the Administration's jobs and growth tax plan, including the proposal to end the double taxation of corporate dividends. We and many other housing and community development stakeholders that work with the Administration are concerned, however, that the dividend proposal in its current form would seriously harm critical community revitalization tax incentives, especially the Low Income Housing Tax Credit (LIHTC). We believe the proposal would also adversely affect the New Markets Tax Credit and the Administration's own proposed Homeownership Tax Credit.

The Committee could address these concerns without undermining the primary policy objectives of the Administration's proposal. For example, the Committee could amend the proposal to treat investments in these tax credits as income on which a corporation paid taxes. The Administration's proposal treats the Foreign Tax Credit in this manner. Other approaches could work as well or better.

We look forward to working with the members of the Committee to protect critical community revitalization tax credits from the adverse effects the Administration's dividend proposal in its current form would have on them.

The Low Income Housing Tax Credit is an Efficient, Effective Program

The Low Income Housing Tax Credit (LIHTC) is one of the most important and successful federal initiatives ever created to provide affordable housing for low-income renters. Congress expanded the Credit by 40 percent in 2000, with the support of 85 percent of all members, including a majority of current members of the Committee.

The LIHTC generates $6 billion in housing investment to produce more than 115,000 affordable apartments for working families, seniors, homeless individuals and people with special needs every year.[1] The Credit annually accounts for most new affordable apartment production and drives up to 40 percent of all multifamily apartment development.[2] The average Credit-financed apartment tenant earns less than 40 percent of their area's median income.[3]

In the course of providing desperately needed affordable housing, the Credit creates jobs and boosts local economies. Each year, the construction and operation of Credit properties generates approximately $8.8 billion of income for the economy, creates 167,000 jobs and produces $1.35 billion in revenue for cash-strapped local governments.[4] The Credit also helps stabilize struggling communities, often spurring additional housing and commercial investment. The Credit has shown the private sector—especially large, sophisticated institutions—that low-income communities can be viable places to do business and that community-based organizations serving the neediest neighborhoods can be good business partners. More corporate and financial institutions are more active in more low-income communities in part as a result of the Credit.

Not only does the private sector provide the capital that fuels the Credit, but also business discipline and oversight that helps account for the extraordinary performance of Credit-financed properties. According to Ernst & Young, the annual foreclosure rate for Credit properties is more than 40 times lower than the rate for all apartment developments and more than 100 times lower than the rate for commercial real estate.[5]

The LIHTC does not operate like a typical government program. Each state receives an annual allocation of Credits based on its population ($1.75 per capita in 2002). States award Credits to developers, including community-based organizations under a competitive process in accordance with annual plans for meeting state housing needs. Developers typically do not have sufficient tax liability to use the Credits so they sell them to corporations and use the cash they receive to finance affordable housing for low-income people. LIHTC-financed apartments must remain affordable to low-income people for at least 30 years.

Two other critical community revitalization tax incentives bear mention. The New Markets Tax Credit (NMTC) was enacted as part of the Community Renewal Tax Relief Act of 2000, which had overwhelming bipartisan support in Congress. The Credit will support $15 billion of investment in economic development and community facilities in low-income neighborhoods over the next several years. The NMTC

[1] National Council of State Housing Agencies, 2003.
[2] Ernst & Young, "Understanding the Dynamics: A Comprehensive Look at Affordable Housing Tax Credit Properties," 2002
[3] General Accounting Office, "Tax Credits: Opportunities to Improve Oversight of the Low-Income Housing Program," 2002.
[4] National Council of State Housing Agencies, 2003.
[5] Ernst & Young, Ibid.

will help finance neighborhood retail centers, small businesses, charter schools and child care centers in distressed areas nationwide.

The Treasury Department's Community Development Financial Institutions Fund administers the program. Fund-certified financing entities with community development missions and community accountability apply to the Fund annually for credits. These entities will sell the credits for cash to corporate institutions and use the proceeds to support their community revitalization projects. The Fund is expected to award the first round of credits, to support $2.5 billion in investment, this month.

The Homeownership Tax Credit (HOTC) is one of the Administration's signature housing proposals. The president first proposed the credit in his 2000 campaign and has included it in his annual budget requests since taking office. Bipartisan House and Senate bills to enact the HOTC have been introduced in the House (H.R. 839, sponsored by Representatives Portman, Cardin and others) and Senate (S. 198, sponsored by Senators Smith, Santorum and Stabenow). The Homeownership Tax Credit has the strong support of most of the housing industry. Enterprise strongly supports the HOTC.

The HOTC is modeled on the highly successful LIHTC. Instead of financing rental apartments, it would encourage the development of for-sale housing affordable to low-income families in distressed communities. States would allocate credits under a competitive process to developers, which would sell them for cash to corporations and use the funds to finance for-sale homes. The Credit would generate $2 billion in financing in its first year. It would produce an estimated 50,000 affordable for-sale homes for low-income people annually.

The Administration's Dividend Proposal Would Severely Weaken the LIHTC

The Administration's dividend proposal would allow shareholders in a corporation to receive either tax-free dividends or, when they sold their stock, a capital gains tax cut. But the proposal would penalize shareholders in corporations that invested in LIHTCs. In most cases, shareholders would pay higher taxes if the corporation had invested in LIHTCs.

Corporations purchase 98 percent of all LIHTCs. Tax Code rules effectively prevent individuals from investing. Corporations do not invest in LIHTCs for the sole purpose of avoiding taxes, but also to finance housing for working families that otherwise would not get built. And corporations cannot simply claim LIHTCs. They have to pay for them and they only get their Credits if the apartments the Credits finance remain in good condition for low-income people for at least 30 years.

If the Administration's plan were enacted, corporations that invest in LIHTCs would have strong incentives not to do so. Many corporations would limit the amount of capital they invest in LIHTCs or lower the price they are willing to pay for them. Lower corporate demand for Credits would drive down their purchasing power and reduce their effectiveness. Less affordable housing for low-income people would be built.

According to Ernst & Young, the Administration's proposal would reduce the number of affordable apartments the LIHTC can produce by 40,000—35 percent—annually, a $1.1 billion cut to housing investment that would affect 80,000 low-income people a year.[6] Developments serving the lowest income people and communities would be disproportionately affected by this cut, according to Ernst & Young.

The impact could be even more damaging than Ernst & Young projects. The report does not take into account the impact of higher interest rates on tax-exempt Housing Bonds the proposal would cause, but notes that it would definitely be adverse and in addition to the effects noted above. Forty-two percent of LIHTC apartments developed in 2001 were financed with tax-exempt bonds.

The report also does not account for the short- and long-term erosion of investor confidence in the program the proposal almost certainly will trigger, which will further cut its purchasing power over time. According to Ernst & Young, some corporations have already deferred making new commitments to invest in LIHTCs as a result of the uncertainty the Administration's proposal has caused. "This has destabilized the Housing Credit equity market and is likely to reduce affordable housing production in the short term," according to Ernst & Young.[7]

We know from experience that uncertainty about the LIHTC's future cripples its purchasing power. In its early years, the LIHTC, like many tax credits, was subject to periodic "sunsets." Relatively few corporations were willing to commit the time,

[6] Ernst & Young, "The Impact of the Dividend Exclusion Proposal on the Production of Affordable Housing," 2003.

[7] Ibid., p. 2.

energy and staff to a program that seemed so precarious. Investors that were in the market then benefited from the general lack of confidence in the program by purchasing Credits for relatively low prices and realizing high returns on their investments. That was bad for the Federal Government because it meant the program was not reaching maximum efficiency. And it was bad for housing, because the Credit was not generating nearly as much housing capital as it otherwise could—and does today.

Now is not the time to cut back on affordable housing development. In 2001, over seven million American renter families—one in five—suffered severe housing affordability problems, spending more than half of their income on rent or living in run down conditions. Meanwhile, the supply of affordable apartments for low-income people drops by 150,000 apartments annually due to rent increases, abandonment and deterioration.[8]

Ernst & Young's analysis is a conservative econometric projection that accounts for the variety of dividend payout policies and shareholder bases among LIHTC investors and a range of shareholder capital gains tax rates. Ernst and Young projects that the Administration's dividend proposal would have adverse effects on the New Markets Tax Credit, Historic Tax Credit and the Administration's proposed Homeownership Tax Credit as well.

The Committee Can Protect the LIHTC Without Undermining the Dividend Plan

We urge the Committee to protect the Low Income Housing Tax Credit, as well as the New Markets Tax Credit and proposed Homeownership Tax Credit, in the legislation to enact the president's economic growth plan. We believe the Committee could do this without significantly undermining the Administration's tax-exempt dividend proposal.

For example, the Committee could amend the proposal to treat investments in these tax credits as income on which a corporation paid taxes. The Administration's proposal treats the Foreign Tax Credit in this manner. Other approaches could work as well or better. For example, we understand that the Treasury Department in 1992 under President George H.W. Bush developed a proposal—after more than a year of study—to tax corporate income only once that would have protected important tax incentives, including the LIHTC. We understand that the Committee is reviewing this proposal.

Once again, Enterprise does not oppose or endorse the Administration's tax-exempt dividend proposal. We are simply seeking a small change to it that would ensure carefully considered bipartisan tax incentives can continue to meet the critical needs Congress created them to address with maximum efficiency and effectiveness.

Thank you for this opportunity to file this statement.

This comment is filed on behalf of The Enterprise Foundation and its affiliated organizations only.

ESOP Association
Washington, DC 20036
March 18, 2003

The Honorable William Thomas
United States House of Representatives
2208 Rayburn Office Building
Washington, DC 20515

The Honorable Charles Rangel
United States House of Representatives
2354 Rayburn Office Building
Washington, DC 20510

Dear Chair Thomas, Ranking Member Rangel and the members of the House Committee on Ways and Means:

On behalf of The ESOP Association and its nearly 2400 members representing all 50 states, I thank you for the opportunity to have our statement on President Bush's tax proposals for the year 2003 placed in the House Committee on Ways and Means' *Hearing on the President's Economic Growth Proposals,* pertaining to H.R. 2, "Job and Growth Tax Act of 2003."

[8] National Council of State Housing Agencies, 2003.

Introduction:

The ESOP Association is a 501(c)(6) advocacy and educational entity that has interacted with your Committee since the Association's beginnings in 1978 on various issues pertaining to this nation's policies related to stock ownership by employees in the companies where they work. These policies are dominated by the ownership and retirement savings structure known as employee stock ownership plan, or ESOP.

Today's statement is limited to commentary on the Administration's tax proposal to eliminate the double taxation on the taxable earnings of corporations in America that are structured in a form called "C" corporations.

Background:

Since 1984, as amended in 1986, as amended in 2001, your Committee has endorsed a corporate level tax deduction for certain dividends paid by a corporation on qualified employer securities held by an ESOP. This corporate level deduction is provided for in Internal Revenue Code Section 404(k). For ease of reading, the Association's statement shall refer to this provision of law as the "ESOP dividend deduction," or "ESOP deductible dividends."

The original ESOP dividend deduction was provided for in the 1984 tax law, known as "DEFRA." DEFRA provided that if dividends paid on ESOP stock were passed-through to the employees in cash, the corporate sponsor of the ESOP could take a tax deduction equal in value to the dividends paid to the employees. The employees, under the law, reported the dividends as current income, and paid an income tax appropriate to the income tax rate applicable to each employee.

In 1986, the ESOP dividend deduction law was expanded by the Tax Reform Act of 1986 to provide that in addition to taking a deduction for dividends paid on ESOP stock passed-through to employees in cash, the corporation could take a tax deduction if the dividends were used to pay the debt incurred to acquire the stock for the ESOP, provided that the employees received stock in their ESOP accounts equal in value to the dividends used to service the ESOP debt.

In 2001, under EGTRRA, the ESOP dividend deduction law was expanded to provide that in addition to taking a deduction for dividends paid on ESOP stock passed-through to employees in cash, and for dividends paid on ESOP stock used to service ESOP debt, the corporation could take the ESOP dividend deduction if an employee voluntarily directed that his or her dividends on the ESOP stock in his or her account was not received in cash, but reinvested back to the ESOP for more company stock.

Specific Effects on ESOPs:

In sum, a corporate level tax deduction is allowed for a corporation paying dividends on ESOP stock under three conditions:

1. Employees receive the dividends in cash
2. Employees receive the dividends in cash, or voluntarily direct that the dividends be reinvested in the ESOP for more company stock
3. The dividends are used to service the debt incurred by the ESOP sponsor in acquiring the ESOP stock if employees have company stock allocated to their accounts in amounts equal to the dividends.

Note, many details of qualifying for the ESOP dividend deduction are left out of this general description, as there are countless rules and regulations, and complicated statutory language that must be adhered to before the ESOP dividend deduction is permitted. For this testimony, only an overview is provided.

So, how does the Administration's proposal impact this valuable ESOP tax incentive, the ESOP dividend deduction?

In reviewing new proposed Code Sections 116, 281,282, and a special rule for ESOPs, proposed Code subsection 286(f), and after discussions with representatives of the Treasury Department, we believe that H.R. 2 provides the following:

1. If the dividends on ESOP stock are passed-through in cash to employees, and the ESOP sponsor takes a corporate level deduction, the employees pay a regular income tax on the dividends they receive.
2. If the dividends on ESOP stock are voluntarily reinvested back to the ESOP for more company stock and the ESOP sponsor takes a corporate level deduction, an employee reinvesting his or her dividend will pay income tax upon distribution from the ESOP to the employee under the various and complex rules governing when an ESOP makes distributions.

3. If the dividends on ESOP stock are used to pay ESOP debt, and the ESOP sponsor takes a corporate level tax deduction, an employee receives stock equal in value to dividends in his or her ESOP account in the form of company stock, and pays tax on the value of that stock upon distribution from the ESOP.

The ESOP Association does not seek any change to H.R. 2 if we are correct in the manner we believe that it will operate. We also understand that these circumstances, if accurately interpreted, the corporation paying dividends should not pay all from its excludable dividends account, that unlike holders of that corporation's stock directly, the ESOP stock will not have a step up in basis.

We do not quarrel with this result, if our interpretation of the proposal is correct.

There is one, seemingly minor interpretation of the Administration's proposal that we feel is unfair, as it seems to violate the core principle of the Administration's proposal that corporate earnings be subject to just one tax. As we interpret the proposal, if a C corporation sponsor of an ESOP pays dividends on ESOP stock, but does not take the ESOP dividend deduction, and passes-through the dividends to the employees, both the corporation and the employees will pay tax on the value of those dividends. This result is totally inconsistent with the view that only one tax is paid on dividends on C corporation stock, as in this situation, two levels of tax are paid.

The ESOP Association respectfully requests that the Committee consider "fixing" the proposal so that when the C corporation foregoes the corporate level tax deduction, the recipient of the dividends who are ESOP participants receive the dividends without paying any tax as the corporation has paid tax, and clearly the dividends are from the excludable dividend account.

Ensuring ESOP Dividends are Taxed Only Once

In that regard, ensuring ESOP dividends are taxed once and only once, The ESOP Association also requests to bring to the Ways and Means Committee's attention other unfair results in current law that if not remedied if Congress adopts the Administration's proposal will result in dividends on ESOP stock paying more than one level of federal tax in certain instances.

To reiterate, if Congress agrees with the Administration's proposal that only one tax should be paid on corporate earnings, then Congress should "fix" current law to ensure that only one tax is paid on earnings on stock that is ESOP stock.

There are two situations to review:

- **ESOP Deductible Dividends and the Alternative Minimum Tax**

First, under current regulations, the IRS has held that dividends deducted pursuant to the ESOP dividend deduction law are a preference item under the corporate AMT. The IRS' position, supported by the Treasury Department, is not clear-cut or without controversy, because neither the 1986 tax law that created the current AMT law, nor the 1989 law that made relevant changes in that law, in order to make it more understandable, explicitly provided that ESOP dividends are a preference item under AMT. Instead, the 1989 law altered an AMT preference that was to tax the differential between what a corporation reported to the SEC as its income and what it reported to the IRS as its income, known as the BIRP preference, to a preference that was to consist of a concept known as the "adjusted current earnings" preference, or ACE.

Congress, in substituting the ACE preference for the BIRP preference, did not spell out what the elements of ACE were, and left it up to the IRS to fill in the blanks.

The IRS filled in the blanks with regulations issued in 1990, that said in no uncertain terms that ESOP deductible dividends were to be part of any ACE calculation, which, in turn was subject to the AMT, assuming the corporation met the thresholds for being subject to AMT.

The ESOP community was duly despondent with the IRS' decision, having protested the proposed regulations with formal comments. The despondency grew as the ESOP community witnessed three ESOP companies challenge the IRS in Federal court, going to the appeals level, and losing.

While a strong case, but obviously not a winning court case, can be made that Congress never intended ESOP deductible dividends to be part of an AMT preference item, an even stronger case can be made that if ESOP deductible dividends are to be taxed at the individual level, as explained above **and** at the corporate level as part of an AMT preference, then ESOP sponsors are, paying a federal tax twice!

So, we would respectfully ask that if the Administration's proposal to tax corporate earnings only once is endorsed by the Committee, the Committee make

sure that dividends on ESOP stock are not taxed twice due to a debatable interpretation of a 1989 law dealing with how ACE is calculated. The statutory fix is simple: by excluding ESOP deductible dividends from the calculation of ACE as an AMT preference.

- **Tax S Corp Distributions from Current Earnings Once**

Turning to the second concern: in the S corporation area, the ESOP community notes what it considers an anomaly in the law that would have never had occurred had the community been more on its toes in 1997 when Congress agreed to new law permitting S corporations to sponsor ESOPs.

As all Committee members know, S corporations only pay one level of tax. In other words, under most circumstances, earnings on S corporation stock already matches the Administration's goal that corporate earnings only be taxed once. In the S area, the one tax is imposed at the shareholder level.

When passing the 1997 ESOP S laws, Congress noted that permitting an S corporation to take an ESOP dividend deduction was not necessary, as the corporation owed no tax. So, in 1997, the Congress made clear that the provision of law that permits C corporations to take a deduction for ESOP dividends was not applicable to S corporations sponsoring ESOPs.

But in doing so, the ESOP community believes Congress unwittingly put in place the imposition of a 10% penalty tax on S corporation distributions from current earnings when passed-through to employees participating in the ESOP. (An S corporation distribution from current earnings is, in essence, a dividend.)

It would seem to be patently unfair that employees with stake holds in S corporations through an ESOP would be subject to a penalty tax that no other shareholders pay.

And, again, should the Administration's principle that corporate earnings are taxed once become law, it would be ironic if S corporation employees were taxed 1.1 times. (In reality the employees are taxed almost "double", as most ESOP employees are in the 10% or 15% tax bracket, and the 10% penalty is a doubling of the federal tax, or a near doubling for taxpayers in those categories. For example, for each dollar of S corporation distribution from current earnings an ESOP employee might receive, he or she probably pays 15 cents in regular tax plus the 10 cents in penalty.)

Of course, the penalty tax on the S corporation's current earnings if passed-through to employees, has resulted in distributions not being passed-through, and the one tax on the earnings being often deferred until there is an ESOP distribution upon the employee's death, disability, retirement, or termination. So, now the distribution from S corporation's current earnings is maintained in the ESOP.

The argument to repeal the 10% penalty tax on the S corporation distributions from current earnings passed-through to employees is self evident, if measured, against the Administration's principle that corporate earnings are to be taxed once and only once.

The ESOP Association recognizes that a counter argument might be made that the ESOP is a retirement savings plan, and no earnings from the plan should be allowed to "leak" out of the plan, making the 10% penalty tax appropriate. In other words, permitting the S corporation distributions from current earnings to pass-through the ESOP is supposedly "bad" retirement savings policy.

Of course under this view of ESOPs, the current ESOP dividend deduction for C corporations should be repealed, as some critics of employee ownership argue.

But Congress has not repealed the ESOP dividend deduction for C corporations, and in fact endorsed this tax incentive for employee ownership in both 2001 by expanding its reach, and in 2002 by summarily rejecting suggestions that the 2001 expansion be repealed. Congress also rejected repeal of the ESOP dividend deduction provision in 1989.

By its actions, Congress has reaffirmed, as Federal Court after Court has recognized, that the laws establishing ESOPs, and the incentives for ESOPs are to promote an ownership policy, as well as a retirement savings policy.

Since 1975, when ESOPs were first recognized, the ESOP community has recognized this dual purpose, and has not run from the fact that those feeling that retirement savings policy is more important than a national ownership policy will dislike, criticize, and even try to have altered those ESOP laws that promote ESOPs as ownership plans. In fact, when President Reagan recommended in 1985 that ESOPs be removed from the ERISA laws of the nation, The ESOP Association did not oppose this initiative, and it was Congress that rejected the proposal and kept the ESOP as an ownership plan in ERISA.

The point is that if Congress, and the Committee in particular, still desire that ESOPs continue to be a major part of this nation's commitment to broad based ownership, it will eliminate the barrier to S corporation employee owners through ESOPs having one aspect of being owners, which is receiving in cash the earnings from their stock, on which they will pay tax as the cash is current earnings in their pockets.

Conclusion

The ESOP Association has only one minor suggestion with regard to the Administration's proposal to tax corporate earning only once, as it impacts the near-20 year-old ESOP tax incentive known as ESOP dividend deduction. The Association suggests that if the Administration's proposal is adopted, then if a corporation does not take the ESOP dividend deduction and pays dividends to ESOP participants, the participants receive the dividends tax-free, as the corporation paid the tax.

Most importantly, however, The ESOP Association urges the Committee to clarify the ESOP deductible dividends, so that they are not subject to the corporate AMT, and that distributions to ESOP participants from S corporations' current earnings not be subject to a 10% penalty tax. These recommendations are necessary to conform current law to the Administration's proposal that corporate earnings be taxed only once.

Again, we thank the Committee for permitting our views to be part of the Committee's record of its hearings on the "*President's Economic Growth Proposals*."

Sincerely,

J. Michael Keeling, CAE
President

Fashion Institute of Design and Merchandising
Washington, DC 20007
March 13, 2003

The Honorable Bill Thomas
Chairman
Committee on Ways and Means
1100 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Thomas,

I thank you for the opportunity to submit our testimony for consideration as the Committee on Ways and Means takes up legislative business to bolster the economy, encourage job creation, and assist America's workforce and families.

History has shown that in tough economic times individuals tend to return to school. This, along with the U.S. Department of Education's recent projections of college enrollments expanding to 16.3 million by the year 2006, place great demands on institutions for plant, property and equipment. Increasing enrollments are certainly a positive for institutions, however, there is significant pressure for institutions to control tuition increases. To underscore this effort to govern tuition increases Representative Howard P. "Buck" McKeon (R–CA) announced on March 5, 2003 that he will unveil the College Affordability Act, mandating that colleges control tuition charges or face the threat of termination of Title IV eligibility. Nonetheless, as reported in the *Chronicle of Higher Education* August 26, 2002 edition, "colleges will be pressed to spend funds to build or refurbish dormitories, laboratories and student centers to deal with the influx of new students."

In order to assist institutions of higher education in meeting the growing student population demand we would propose amending the Job Creation and Worker Assistance Act of 2002 (Section 168(k)) to allow a 30% additional first-year depreciation for buildings and improvements for tax-paying colleges.

We believe the following objectives would be served with such an amendment.

- Due to the uncertainty caused by September 11, 2001, and the resultant dip in the economy, this is a time when most businesses, colleges included, are scaling down their growth plans through investments in long-lived assets. The additional 30% depreciation would allow colleges to continue to reinvest in the innovative and leading technologies that keeps our workforce at the forefront of the world.
- This plan would tie in additional tax savings to reinvestments in technology assets, and would ensure reinvestment in the economy.

- After September 11, 2001 additional reporting requirements were mandated by the INS for tracking foreign students attending U.S. institutions after January 2003. These new administrative reporting requirements add to college costs, therefore some additional tax relief would benefit institutions in their efforts to control tuition increases.
- By limiting the amendment to higher education institutions to those that are degree-granting and regionally accredited the proposal stays cost-effective.
- There is a very real fear of expansion right now among schools, and this bill would go a long way to eliminating it.
- There is a proven trend that when the economy slows down, more people return to school as they lose jobs or struggle to support themselves. Postsecondary educational institutions were overtaxed prior to September 11, 2001 with an inability to accommodate all of the incoming students. Those who do choose to attend higher education, or return to school, should be supported by the government because they are reinvesting in their own futures as well as that of the nation.

We would respectfully suggest amending the Job Creation and Worker Assistance Act of 2002 as follows:

If an institution of higher education that is regionally accredited and provides a 2-year or 4-year program of instruction for which the institution awards an associate or baccalaureate degree has invested in the purchase of a building and building/leasehold improvements or has done so through a related corporation and that institution has substantial equity in these school-occupied facilities, then that institution will be eligible to take a 30% additional first-year depreciation deduction for buildings or improvements if acquired or contracted for after September 11, 2001 and before September 11, 2004. The income tax savings related to this 30% reduction must be reinvested into technology assets by the institutions utilizing this deduction.

Our cost analysis for such a proposal is as follows:

New tax revenues would be generated by creating new technology sector sales. As part of the bill, all dollars saved would translate to additional sales in tech markets, increasing that sector's taxable income. The amendment would stimulate the economy over the short and long term by providing much needed facilities for students, providing them with more current access to latest innovations in technology, create an influx of sales in the troubled technology sector, and create more tax revenue for the Federal Government by the middle of the third year after investment.

Assumptions	
Facilities purchased or constructed before 9/11/2004.	
Effective tax rate	34%
Number of institutions	228
Percentage that might utilize	50%
Assumed cost per facility	10,000,000
Total investment in facilities	1,140,000,000
Current law annual depreciation	28,860,759
30% Bonus (tax savings reinvested in tech assets)	342,000,000
Technology assets purchased	116,280,000
Revised annual depreciation	25,916,962
Current law depreciation tech assets Y–1	23,256,000
Current law depreciation tech assets Y–2	37,209,600

Assumptions	
Current law depreciation tech assets Y–3	22,325,760
Current law depreciation tech assets Y–4	13,395,456
Current law depreciation tech assets Y–5	8,037,274
Current law depreciation tech assets Y–6	12,055,910 116,280,000
30% Bonus (tech assets)	34,884,000
Revised depreciation tech assets Y–1	16,279,200
Revised depreciation tech assets Y–2	26,046,720
Revised depreciation tech assets Y–3	15,628,032
Revised depreciation tech assets Y–4	9,376,819
Revised depreciation tech assets Y–5	5,626,092
Revised depreciation tech assets Y–6	8,439,137 116,280,000

Taxes collected	Increase (reduction) in taxes	Technology sector	Total effect
Year 1 differential	(124,767,557)	116,280,000	(8,487,557)
Year 2	4,796,270		4,796,270
Year 3	3,278,119		3,278,119
Year 4	2,367,228		2,367,228
Year 5	1,820,693		1,820,693
Year 6	2,230,594 (110,274,653)		32,528,962
Years 7–39.5 differential	1,000,891		38,534,309

We appreciate this opportunity to submit our testimony before the Committee on Ways and Means. Should you need additional information please feel free to contact us.

Sincerely,

Norine Fuller
Executive Director of Student Financial Services

Statement of the Honorable Peter Hoekstra, a Representative in Congress from the State of Michigan

The President has proposed an ambitious economic stimulus package, several components of which I believe will spur economic recovery, including making those tax cuts signed into law in 2001 permanent and creating incentives for business to invest.

The struggling economy and uncertainty in the tax code has business unsure of the future. One way Congress can eliminate that uncertainty is to make permanent those tax cuts.

The Economic Growth and Tax Relief Reconciliation Act of 2001 provided tax relief in nearly every tax bracket. It repealed the death tax, provided marriage tax relief, expanded the Earned Income Credit, raised IRA contribution limits and simplified the tax code, making it easier for families to save and invest for the future.

By not making those cuts permanent, an already complex tax code will become even more difficult for individuals and businesses to navigate. People and businesses need certainty to plan. Taxpayers should not be held to the whims of Congress.

Another aspect of the President's proposal, providing for a larger expensing allowance, is necessary to create jobs and strengthen the manufacturing sector.

The President's plan calls for the elimination of the double taxation on dividends. This provision might provide long-term growth in the economy, but I feel it is necessary to provide our business sector, particularly manufacturing, with more immediate relief.

American manufacturing is innovative, productive and efficient. It is estimated that the manufacturing sector contributes more than 60 percent of U.S. investment in research and development.

However, over the past two years, more than 10,000 office furniture workers in West Michigan lost their jobs. Today, manufacturers in Michigan's Second Congressional District wonder whether America will retain a viable manufacturing sector.

Nationwide more than 2 million manufacturing jobs, paying an average annual wage of $46,000, have been lost in the last two and half years.

Providing for additional expensing for small business is a step in the right direction, but while the President proposes to increase the annual deduction and raise the annual allowance for small businesses, the committee needs to consider reaching even farther.

I support increasing the three-year, 30 percent expensing allowance in the Job Creation and Worker Assistance Act of 2002 to 100 percent for all American businesses. This is why I co-sponsored H.R. 771, the Full Expensing for Economic Growth Act of 2003.

This legislation allows businesses to depreciate 100 percent of their equipment purchases over the next 18 months. Every dollar devoted to an enhanced expensing allowance will go into new capital investment in the United States, which will result in increased productivity and higher wages.

Increasing the expensing allowance acts as super-accelerated depreciation by "front-loading" the deduction allowed. Thus, the long-term federal budget impact is minimal because it does not increase the total depreciation deduction. Also, it would increase total sales of capital equipment and thereby generate additional tax revenues.

In the face of a weak economy, businesses need a very compelling reason to move forward with, rather than defer, capital purchases. Increasing the expensing allowance would create this positive effect.

I also believe we need to closely examine the possibility of reinstating an investment tax credit of 10 percent for all new equipment purchases.

Reducing the tax burden on American businesses with an investment tax credit of 10 percent would spur greater spending on equipment, increase capital investment and would seriously boost the manufacturing sector of our economy.

As we discuss different aspects of the proposed jobs and growth plan, the current proposal to eliminate the double taxation on dividends deserves the closest scrutiny.

While many other provisions provide an immediate or short-term boost to spending and investment, there is contradictory evidence regarding the effect of the dividend provision.

Congressional Research Service had this to say about the dividend proposal:

> *"Using dividend tax reductions to stimulate the economy is unlikely to be very effective because, unlike direct government spending or tax cuts for lower and moderate income individuals, it is not as likely to directly increase spending, which is the most effective way to stimulate the economy."*

The dividend proposal accounts for nearly half the estimated revenue loss associated with the President's growth package over the next 10 years. Estimates suggest that dividend exclusions for individual taxpayers would cost some $25 billion per year.

I agree with Federal Reserve Chairman Alan Greenspan's measured support for this proposal contingent on whether its implementation increases or decreases rev-

enue. Further, I consider this proposal an investment in the long-term health of our economy.

But just as every household budget must first pay for the needs of today and then put leftover funds into long-term investments, Congress must also. In a time of budget deficits and uncertain foreign policy costs, revenue loss needs to be balanced with prudent fiscal policy.

Statement of the Investment Company Institute

The Investment Company Institute (the "Institute")[1] is pleased to submit for the Committee's consideration this statement strongly supporting the President's proposal to promote economic growth and encourage savings by eliminating the double taxation of corporate earnings. The dividend exclusion incorporated in H.R. 2 achieves this objective through provisions that are designed to maximize economic efficiencies and minimize administrative burden. This legislation represents an important step in enhancing the ability of Americans to meet their own needs for long-term financial security.

The Institute has discussed the dividend exclusion proposal with Treasury Department representatives on numerous occasions and with Committee staff. We appreciate greatly their receptivity to our suggestions for modest, conforming changes that will make the proposal even more administrable for investors generally and, more particularly, for the millions of mutual fund shareholders investing for the future in equities through taxable accounts.

I. The Need to Encourage Savings

Encouraging Americans to save for their long-term financial security is of vital importance to our nation's future. As Dr. Rudolph G. Penner stated at the beginning of his paper, "Reducing the Tax Burden on Saving," that was published by the Institute in 1994, a nation's savings provide the foundation for its economic growth. Nations that do not save will in the long run see their potential for increased income and wealth suffer. For that reason, the current savings rates in the United States, low by historical and international standards, raise concerns that the United States will grow more slowly than it should and that the standard of living of its citizens will be lower than it need be. The cause of the falling savings rate has been the subject of much debate. Although the cause is not clear, the trend may be reversed by reducing the tax burden on saving.[2]

II. The Mutual Fund Industry's Role in American Saving

Mutual funds play an important financial management role for over 90 million Americans. Overwhelmingly, these investors are middle-income Americans who invest in mutual funds for the diversification, professional management and varying investment objectives that funds provide. Americans may invest in funds through taxable accounts, retirement accounts, or qualified tuition programs (more commonly known as Section 529 Plans). As these funds have grown, they've played a leading role in democratizing our financial markets. American investors now represent a broad cross-section of society and a powerful engine for economic recovery.

At the end of 2003, U.S. mutual funds had total assets of $6.391 trillion. Of this amount, approximately 42 percent (or $2.667 trillion) was invested in equity funds, approximately 18 percent (or $1.125 trillion) was invested in bond funds, approximately 5 percent (or $0.327 trillion) was invested in hybrid funds,[3] and the remaining 35 percent (or $2.272 trillion) was invested in money market funds.[4]

Mutual funds function as an important investment medium for employer-sponsored retirement programs (*e.g.,* section 401(k) plans) as well as for individual savings vehicles (*e.g.,* individual retirement accounts ("IRAs")). As of December 31,

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,929 open-end investment companies ("mutual funds"), 553 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.322 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

[2] "Reducing the Tax Burden on Saving," p. 1, Investment Company Institute, December 1994, located on the Institute's Mutual Fund Connection website at www.ici.org/newsroom/pub/1rpt_penner.pdf

[3] A hybrid fund is one that invests in a combination of stocks, bonds and other securities.

[4] *Mutual Fund Industry Developments in 2002,* Perspectives, Vol. 9, No. 1, Investment Company Institute (February 2003), located on the Institute's Mutual Fund Connection website at www.ici.org/newsroom/pub/per09-01.pdf

2001, mutual funds held approximately $2.3 trillion in retirement assets, including $1.2 trillion in IRAs and $1.1 trillion in employer-sponsored defined contribution plans.[5] These figures represented about 49 percent of all IRA assets and 44 percent of all 401(k) plan assets.

While many are aware that more than half of all U.S. households invest in mutual funds, the impact that growing mutual funds have had on the economy is less fully appreciated. A few years ago, *The Economist* said that mutual funds had emerged as "the biggest source of capital for American companies . . . giving small and medium-sized businesses unprecedented access to capital markets and thereby financing nearly all of America's employment growth."[6]

In short, mutual funds are both an essential vehicle for enabling middle-income Americans to reach their long-term savings goals, including retirement, and an important source of capital and growth for the American economy.

III. Application of the Dividend Exclusion to RICs and Their Shareholders

A. General Rules

Under the President's proposal, a corporation's fully-taxed earnings may be distributed tax-free to the corporation's shareholders either as a tax-free cash distribution (an "excludable dividend" or "ED") or by adjusting upward the cost basis of each shareholder's shares (a "retained earnings basis adjustment" or "REBA"). Once a corporation distributes its earnings as an ED or a REBA, no further income tax will ever be imposed on those earnings.

A corporation also can make a tax-free distribution to its shareholders, under the President's proposal, out of its "cumulative retained earnings basis adjustment amount" or "CREBAA" and reducing the amount of its cumulative REBAs by the amount distributed. A cumulative retained earnings basis adjustment ("CREBA") distribution is treated in the hands of an investor exactly the same as a return of capital; each provides tax-free cash to the investor (to the extent of the shareholder's basis) and requires a downward adjustment in share basis equal to the cash distributed.

B. regulated investment company ("RIC") Rules

The dividend exclusion tax benefits provided to direct investors in equity securities also are provided under the President's proposal to the shareholders of a fund organized as a regulated investment company ("RIC") under Subchapter M of the Code, hereinafter referred to as a "fund." A fund that receives EDs, REBAs and CREBAs on its portfolio stocks could pay/allocate them periodically to its shareholders on a flow-through basis. Funds may be expected under the President's proposal to pay EDs and allocate REBAs frequently, as fund shareholders would benefit from an ED or REBA only to the extent that it had been paid or allocated by the fund to its shareholders.

Many millions of mutual fund shareholders would not need to individually make the basis adjustments required by the REBA and CREBA regimes, as they already are entitled to receive average cost basis statements provided to them voluntarily by their funds. Once the funds have modified their cost basis programs for REBAs and CREBAs, the funds themselves would make the necessary adjustments to the cost basis of their shareholders' shares. Those shareholders who either do not receive, or choose not to use, average cost basis statements provided to them by their funds would need to make these adjustments themselves (such as with the use of a computer program designed for this purpose) or rely on their tax return preparers or financial advisors to assist them.

C. Retirement Accounts

The President's proposal does not apply to retirement accounts. As noted in the Treasury Department's General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals, "[b]ecause all investment income is effectively free from tax in Retirement Plans, investments in these plans will remain tax advantaged relative to investments outside of these plans."[7]

[5] *Mutual Funds and the Retirement Market in 2001*, Fundamentals, Vol. 11, No. 2, Investment Company Institute (June 2002) located on the Institute's Mutual Fund Connection website at www.ici.org/newsroom/pub/fm-v11n2.pdf.

[6] "The Seismic Shift in American Finance: Mutual Funds," *The Economist*, October 21, 1995.

[7] "General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals," p. 21, U.S. Department of the Treasury (February 2003).

IV. The Dividend Exclusion's Impact on Savings

The mutual fund industry's role in Americans' efforts to achieve financial security provides the Institute with a unique perspective with respect to the dividend exclusion and its impact on various savings opportunities.

The proposal would have a strong, positive impact on taxable investing in equities. Eliminating the investor-level tax on corporate dividends would substantially increase after-tax returns on equities which, in turn, should raise stock prices and promote long-term savings.

The impact of the proposal on municipal bonds most likely would be modest. Although the proposal would raise the risk-adjusted after-tax return on equities relative to bonds, equities and municipal bonds are not generally viewed as ready substitutes for each other. Taxable bonds are a far better comparable for municipal bonds, and the relative after-tax yield on the taxable bond versus the municipal bond yield is often the determining factor in deciding whether to invest in municipal bonds.

Finally, although the proposal does not apply to equities held in a retirement account, any investor eligible to make pre-tax contributions to a retirement account or after-tax contributions to a Roth IRA would still receive more favorable treatment by investing in the retirement account than by investing in the same assets through a taxable account. This result would occur unless 100 percent of the return on a stock was in the form of a tax-free distribution of an ED, a REBA or a CREBA.[8] Moreover, retirement accounts investing in equities would receive the same benefit that taxable accounts would receive from the rise in stock prices generated by the proposal. Thus, investors would continue to have an incentive to hold equities through their retirement accounts and would benefit from the proposal's positive impact on the stock market.

V. Mutual Fund Capital Gains

The Institute supports legislation that would permit the deferral of the payment of tax on a capital gain realized by a fund until the fund shareholder receives the gain in cash, such as by redeeming fund shares. This proposal would remedy the anomalous result, misunderstood by many fund shareholders, that capital gains realized by the fund are taxed currently to the fund's long-term mutual fund shareholders—who continue to hold, rather than sell, their shares.

If this type of legislation were enacted, the fund shareholder's own actions would determine when taxes are paid. This would benefit the millions of fund shareholders investing in taxable accounts. These investors are mainly middle-income investors who are providing capital necessary for continued economic growth.

By reducing current tax bills and allowing earnings to grow tax-deferred, this legislation would boost long-term savings. Moreover, the proposal would not result in these gains being excluded from tax. Instead, the gains would merely be deferred, albeit, in some cases, outside the relevant budget-scoring period. The proposal's boost to long-term savings would have little, if any, long-term cost and would provide benefits to the economy in both the short run and the long run.

VI. Institute Support for Other Savings Initiatives

Finally, the Institute has long supported efforts to enhance financial security by advocating efforts to encourage retirement savings through employer-sponsored plans and IRAs, to simplify the rules applicable to retirement savings vehicles, to enable individuals to better understand and manage their retirement assets, to encourage college savings, and to reduce the tax burden on other long-term investing through mutual funds.

The President's budget includes several important savings incentives, in addition to the proposal to eliminate the double taxation of corporate earnings. One bold initiative is the proposed creation of Retirement Savings Accounts, Lifetime Savings Accounts and Employer Retirement Savings Accounts. These three new retirement and savings vehicles would both enhance the ability of Americans to save for their future and simplify the current rules governing retirement plans. The Institute strongly supports savings and simplification initiatives that would bring long-term savings and investment opportunities within the reach of every working American.

The President's budget detailed other important retirement savings initiatives that the Institute endorses, including proposals to accelerate the savings enhancements, and make permanent the pension law enhancements, that were enacted two

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[8] As noted above, retirement accounts effectively provide a zero rate of tax on return. In contrast, a taxable account would only provide tax-free treatment on the portion of the investment return attributable to EDs, REBAs or CREBAs.

years ago as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").

The Institute supports accelerating the phase-ins of the increases, enacted as part of EGTRRA, in the contribution limits to IRAs and employer-sponsored retirement plans and in the opportunity for individuals age 50 and over to make "catch-up" contributions to their pension plans and IRAs. Accelerating the phase-ins will increase saving and boost economic growth.

The Institute also supports making permanent as soon as possible the EGTRRA enhancements to our pension laws—which likewise encourage economic growth. For individuals to plan appropriately for their retirement years, they must be able to rely on predictable rules—rules that apply now and throughout one's career and retirement.[9] The future termination of these provisions could affect the long-term savings strategies of working individuals, undermining the purpose of these reforms and jeopardizing saving and long-term growth.

Because education helps increase productivity, saving for higher education promotes economic growth in both the near-term and the long-term. The Institute supports prompt enactment of legislation making permanent the tax-free treatment of qualified withdrawals from Section 529 plans because of the disproportionate impact that this uncertainty is having today. EGTRRA provides no up-front benefit to taxpayers, but instead provides that future qualified withdrawals will be tax-free. Consequently, EGTRRA's sunset provision creates immediate uncertainty for families who are trying to save now to meet college expenses that will arise after 2010. Legislation making permanent the tax-free treatment of qualified withdrawals from these plans will promote growth and encourage long-term savings. For this reason, it should be a priority.

VII. Recommendation

The Institute strongly supports common-sense initiatives that will promote savings. Thus, we urge enactment of the H.R. 2 provisions that would eliminate the double taxation of corporate earnings. We support capital gains tax relief for mutual fund shareholders. Finally, we also support savings incentives for retirement and college education.

SUMMARY POINTS

STATEMENT OF THE INVESTMENT COMPANY INSTITUTE
ON THE PRESIDENT'S economic growth proposals

included in the FISCAL YEAR 2004 BUDGET
SUBMITTED TO THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

I. The Need to Encourage Savings

Encouraging Americans to save for their long-term financial security is of vital importance to our nation's future.

II. The Mutual Fund Industry's Role in American Saving

Mutual funds play an important financial management role for over 90 million, overwhelmingly middle-income, Americans who invest in mutual funds through taxable accounts, retirement accounts and qualified tuition programs (Section 529 Plans).

III. Application of the Dividend Exclusion to Mutual Fund Shareholders

The proposal's tax benefits would be provided to direct investors and mutual fund shareholders. Funds may be expected to distribute these benefits frequently to their shareholders. Those millions of mutual fund shareholders who receive average cost statements from their funds would have all calculations performed for them.

IV. The Dividend Exclusion's Impact on Savings

The Institute strongly supports this proposal because it most likely would have a strong, positive impact on taxable investing in equities and a modest impact on

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[9] Americans will be better positioned to build an adequate retirement plan if they know now whether, for example, they will be able to contribute $2,000 or $5,000 to an IRA in 2011 and whether they will be able to make catch-up contributions.

municipal bonds. Although the proposal would not apply to equities held in a retirement account, investors would continue to have an incentive to hold equities through their retirement accounts and would benefit from the proposal's positive impact on the stock market.

V. Mutual Fund Capital Gains

Finally, the Institute supports legislation that would permit the deferral of the payment of tax on a capital gain realized by a fund until the fund shareholder receives the gain in cash, such as by redeeming fund shares.

VI. Institute Support for Other Savings Initiatives

The Institute has long supported efforts to enhance financial security by advocating efforts to encourage retirement savings through employer-sponsored plans and IRAs, to simplify the rules applicable to retirement savings vehicles, to enable individuals to better understand and manage their retirement assets, and to encourage college savings.

Statement of International Pizza Hut Franchise Holders Association (IPHFHA), Advisory Council for Taco Bell Franchisees (FRANMAC), Association of Kentucky Fried Chicken Franchisees, Inc. (AKFCF), National A&W Franchisees Association (NAWFA), and Association of Long John Silvers Franchisees, Inc. (LJS)

Mr. Chairman and members of the Ways and Means Committee, thank you for the opportunity to submit testimony on the critically important issue of economic growth, specifically the impact depreciation relief contained in proposals such as H.R. 571 could have in creating jobs and speeding up our nation's economic recovery.

We are speaking on behalf of franchisees from the following restaurant concepts: Taco Bell, Pizza Hut, KFC, Long John Silvers and A&W. Restaurant franchisees are generally small business people who own and operate restaurants in their local communities under franchise agreements which give them access to the franchisor's trade name and business system. Franchisees are responsible for acquiring restaurant property, constructing the actual facility, employing its workers, and overseeing the day-to-day operations of the restaurant.

Background

Under current tax law, owners of most commercial buildings, quick-serve restaurants included, must depreciate their building's original cost, plus any subsequent renovation or improvements, over a 39-year cost recovery period. In the past, Congress has sped up this schedule for certain types of businesses whose facilities incur an unusually high degree of wear and tear such as gas stations and, more recently, convenience stores.

It is unrealistic to believe that a restaurant building has a useful life of 39 years. Restaurants, especially quick-serve restaurants, see a very high-volume of business every day and are open seven days a week, many up to 24 hours per day. Restaurants constantly have to renovate and update in order to comply with state and local building, health, and safety codes not to mention meeting the ever-changing tastes of discerning consumers.

In fact, National Restaurant Association studies show that most restaurants remodel and update their buildings every six to eight years, nowhere near the 39-year depreciation timeframe provided in current law. Our restaurant buildings simply do not last that long without major renovations. When a restaurant does renovate, those costs must then be depreciated on yet another 39-year cost recovery period, which often times makes remodeling an unattractive proposition.

Also, many franchise agreements contain "scrap and rebuild" provisions obligating franchisees to build a new facility from the ground up once their original restaurants reach a certain age. This means franchisees often have to build a new restaurant well before their costs incurred from the original restaurant have been recovered.

Even if restaurant franchisees did not have major renovations to do and were not subject to "scrap and rebuild" provisions, many franchise agreements do not provide automatic rights of renewal past the expiration at 20 years. One of the basic accounting principles requires matching revenues with expenses. When a 20-year franchise contract is carried out in a building with a 39-year depreciation period, it be-

comes very clear that the depreciation expense applicable to the building is not in step with the income generated over the life of the franchise agreement.

Legislation

Taco Bell FRANMAC strongly supports legislation to remedy this disparate tax treatment such as H.R. 571 introduced by Congressman Mark Foley. H.R. 571 shortens the current 39-year depreciation schedule to a much more reasonable 15-year period which would allow restaurants to recover the costs of buildings and improvements over a shorter period of time. H.R. 571 would apply to restaurant buildings placed in service after the date of the enactment and to all improvements made after that same date.

Economic Impact

In addition to rectifying the disparity between the normal use-life of a restaurant facility and the tax code's current depreciation period, this legislation will also serve as a major impetus for improving the economy given the number of typically small businesses that are put to work when building or renovating a particular restaurant facility. For instance, local bankers and real estate brokers benefit from financing the costs associated with building and remodeling, local architects gain from the design and planning aspects, and roofers, plumbers, electricians and carpenters all benefit from the resulting construction project itself. Add in local landscapers, signage companies, and pavement contractors and you can easily see how depreciation relief could directly and immediately stimulate our local and national economic recovery.

H.R. 571's economic impact will be felt across the country, in both small towns and large cities, since franchise restaurants are located in every Congressional district in the country. In fact, the average Congressional district is home to between 25 and 75 restaurants from the above five franchise concepts alone.

The International Franchise Association ("IFA") recently asked some of its similarly situated members in an informal survey what depreciation reform would mean to their business:

- Burger King reports not one original restaurant structure was still standing after 39 years. The typical Burger King restaurant facility undergoes building improvements every seven to ten years. In addition, Burger King's 20-year franchise agreement requires franchisees to "scrape and rebuild" restaurants before renewal.
- A Dunkin' Donuts multi-unit franchisee reports that while his franchise agreement is for 20 years, he is obligated to remodel every ten years. However, the shops require remodeling about every seven years.
- International Dairy Queen estimates that its small percentage of company-owned stores would be able to increase the allowed depreciation taken over the first five years by $15,000 for remodeling and $67,800 for new construction. This is the savings for one restaurant and represents the accumulated increased depreciation deduction over the entire five-year period.
- We calculate the tax savings to be in the $6,000 per year/store range on a typical Taco Bell or KFC franchise building.

Leveling the playing field

H.R. 571 will also level the playing field with certain convenience store operators that have recently become direct competitors with quick-serve restaurant franchisees in many cases. In 1996, Congress provided a 15-year depreciation schedule for gas stations and convenience stores. Since then their food service options have expanded to include deli's, burgers, pizza, tacos and chicken. From 1997 to 1999 foodservice sales generated by these competing products in gas stations and convenience stores grew 64%. In fact, food prepared on site has taken over dispensed beverages as the largest segment of convenience stores' foodservice sales. Our restaurant franchisees operate in a very competitive environment and request that the Committee modernize the tax code to reflect these real world conditions.

Conclusion

Franchising accounts for over $1 trillion in U.S. retail sales and more than eight million jobs. The restaurant industry is the nation's largest private employer with over 11.2 million workers.

Shortening the current 39-year depreciation schedule to 15 years would stimulate both short- and long-term economic growth and create jobs in not only the restaurant industry, but in the trades and businesses that will indirectly benefit from the construction and renovation of restaurant buildings as well.

We hope the Ways and Means Committee will include H.R. 571's depreciation relief in the economic stimulus package currently before Congress. Thank you again for the opportunity to present this testimony.

1204 Wyandotte Road
Columbus, Ohio 43212
February 3, 2003

The Honorable Robert Portman
United States House of Representatives
238 Cannon House Office Building
Washington, D.C. 20515

Dear Representative Portman:

I wanted to write you to show my support for the Administration and President Bush's efforts to reform the Internal Revenue Code in efforts to stimulate the national economy. Unfortunately I am concerned, however, that the Treasury Department's formulation for ending the double taxation of corporate dividends will have the unintended consequence of diminishing the flow of private capital into affordable housing financed with the Low Income Housing Tax Credit (LIHTC). I urge you to ensure that no harm is done to the LIHTC when you consider legislation designed to incorporate the Administration's policy to end the double taxation of corporate dividends (the "dividend proposal").

I have personally been involved in affordable housing for over 13 years. The LIHTC generates equity for such investments in affordable housing. The current proposal to reform the Internal Revenue Code could greatly hamper efforts to create and preserve affordable housing in Ohio for Ohioans.

As you may know, LIHTC is involved in virtually all of this Nation's affordable rental units and at least 40 percent of all multifamily housing starts are made possible through the LIHTC. Since 1986, LIHTC has generated private equity investments in more than 1.5 million units of new or rehabilitated safe, decent housing for low- and moderate-income seniors and families.

According to some estimates, every $1 invested in housing credits will "taint" $1.86 of earnings by subjecting them to double taxation of dividends. So, corporations who currently provide 98% of LIHTC equity nationwide will be forced to make the choice between reducing corporate taxes and supporting the creation of affordable housing OR passing the maximum amount of tax-free dividends on to shareholders.

LIHTC was initiated by President Reagan, extended and strengthened by President George H.W. Bush and permanently extended and increased by President Clinton. It is a bipartisan program that works very well. LIHTC began as a means to provide an efficient alternative to direct subsidies for meeting the Nation's affordable housing needs. The program has proved very successful. Under the Treasury Department's formulation of the dividend proposal, however, the hallmark success and efficiency of this program will be greatly diminished.

I am also concerned that the Treasury's formulation of the dividend proposal will significantly reduce the value of the New Markets Tax Credit, enacted in 2000, and President Bush's new Homeownership Tax Credit. I urge you to preserve the value of these credits, as well as the LIHTC, in any legislation in which you consider the implementation of the dividend proposal.

I look forward to working with you to preserve the LIHTC as an essential tool in preserving and producing affordable housing in our State and Nation. Let us not disassemble a valuable tool in providing for families in Ohio and throughout the country at a time when our Nation's people and economy can ill afford it. If you have any questions please feel free to contact me at 614–353–5353.

Sincerely,

John F. Kukura III

Statement of the Mortgage Bankers Association of America

Estimated Impact of the Major Components of the Bush Administration's Growth and Jobs Plan on Housing and the Economy

Executive Summary

The halting and weak nature of the current economic recovery and the related lack of job creation have led to the proposal that fiscal policy be used to encourage greater economic growth. February payroll employment declined by over 300,000 jobs affecting all sectors of the economy. Fourth quarter Gross Domestic Product (GDP) increased a paltry 1.4 percent at an annual rate. House price increases are slowing, increasing the likelihood that the strong support provided by the housing sector will moderate somewhat toward a more historically normal role, but raising the risk of slowing consumer spending. While some signs of strengthening can be observed, the Federal Reserve Board has noted that there is still greater risk of weak economic growth than of resurgent inflation.

The Bush Administration has proposed a defined package of policies for the purpose of increasing economic growth and accelerating job creation. In light of the challenges faced by the economy and the importance of job and income growth to both the residential and commercial real estate finance industries, it is prudent for the Mortgage Bankers Association of America (MBA) to evaluate the impact of the proposal on the economy and real estate.

The two main elements of the Administration's proposal are the acceleration and making permanent of the previously enacted marginal tax rate cuts and the elimination of the double taxation of corporate dividends. The MBA incorporated the combined package into a simulation of economic activity for purposes of evaluating the capacity of the proposal to increase job formation and income growth in the next two years, a period of time over which the full effects should play out.

Simulation results produced by MBA, and based on conservative assumptions, show that the effects predicted by the Administration's economic advisors are supported, with any differences within the tolerances of such models. Our estimates anticipate an annualized increase of 0.9 percent in GDP growth by year-end 2004 and the addition of 1.0 million jobs in that same time frame. The proposal will have a minimal impact on mortgage interest rates and will generate an additional 130,000 housing starts over the simulation time frame.

As a result of the estimated positive effects on the economy and the related benefits for the commercial and residential real estate sectors, MBA is strongly recommending the adoption and implementation of the proposal as soon as possible.

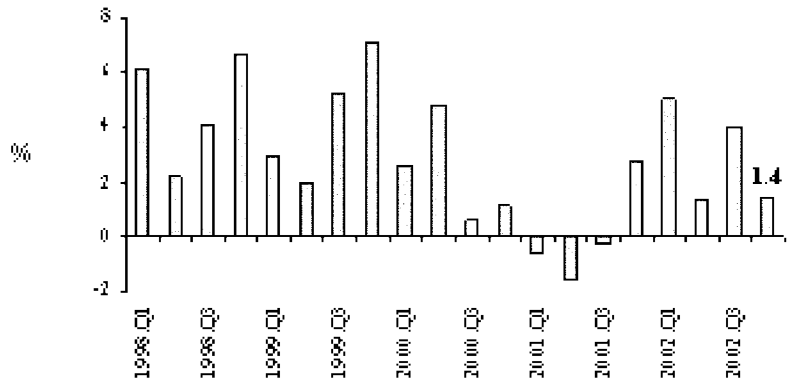
Current Economic Environment

The recovery of the U.S. economy from the recession that began in 2001 has been modest and uneven and has failed to produce a desirable level of job growth. As a result, the Bush Administration has proposed an economic growth package intended to increase both employment and GDP growth.

Growth of Gross Domestic Product (GDP) began decelerating in the second half of 2000 and became negative at the outset of 2001.

Real GDP Growth

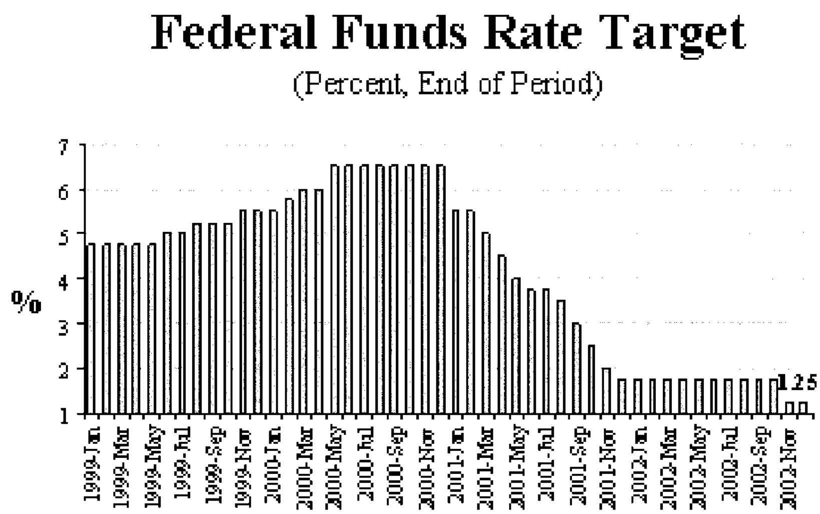
(Percent change, Seasonally Adjusted at Annual Rate)



Source: U.S. Department of Commerce

After three consecutive quarters during which the annualized rate of GDP growth was negative, national income growth turned up but at an erratic pace. The preliminary GDP estimates for the fourth quarter of 2002 stand at 1.4 percent, well below the economy's long-run capacity for growth and well under the pace normal for this far beyond what appears to have been the end of a recession and the beginning of an expansion.

Monetary policy has been accommodative since the onset of the recession. The Federal Reserve has lowered the Federal Funds Rate Target both rapidly and to a very low level.



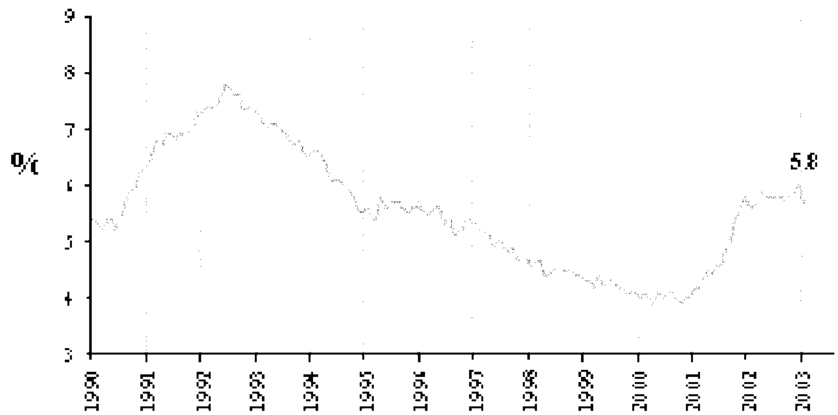
Source: Federal Reserve Board

The most recent cut in the Fed Funds target, November 2002, to 1.25 percent was accompanied by commentary indicating that the observed softening of activity in the manufacturing sector indicated that the risks to the recovery of the economy remained significant and growth-oriented rather than inflationary. The Federal Reserve Board has been very clear that it will retain an accommodative policy stance until such time as it sees a solid footing established under the recovery; something that it does not yet see.

Unemployment, which began to rise in late 2000, has remained stubbornly high, most recently reported in February 2003 at 5.8 percent.

Unemployment Rate

(Percent, Monthly Average)

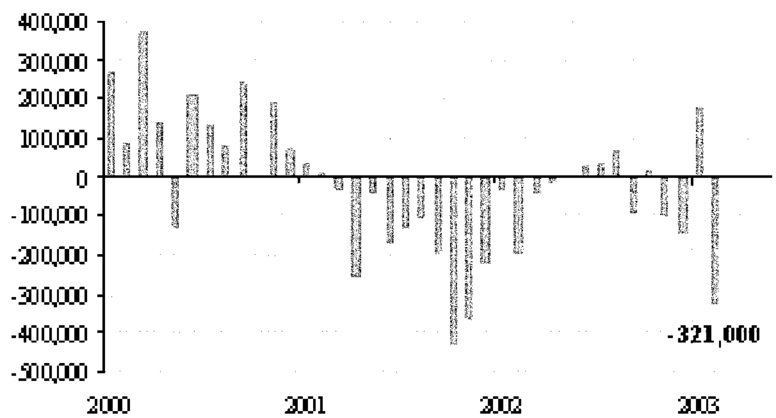


Source: BLS Household Survey

The February report indicated private nonfarm payroll job losses of 321,000.

Employment Growth

(Monthly Change in Private Nonfarm Employment, Number of Jobs)

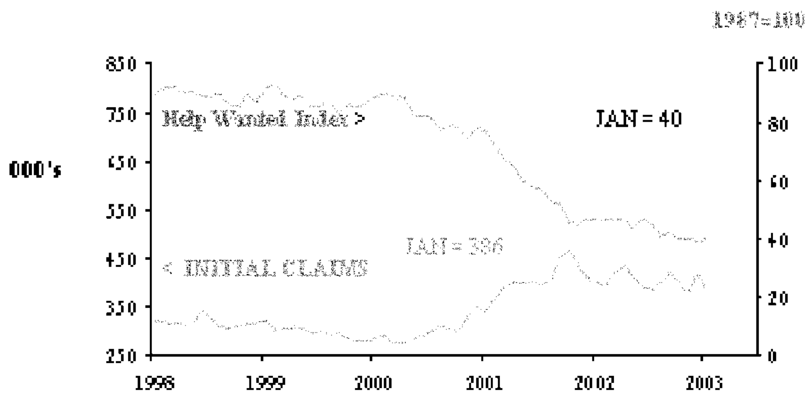


These losses were not concentrated but rather were reflected in all broad categories of employment with retail trade and services suffering the largest losses. Manufacturing continued to register job losses. Additionally, the rate of initial un-

employment claims have remained relatively high and the Help Wanted Index gives no indication of a trend shift toward improved employment conditions.

Unemployment Insurance Claims and Help Wanted Index

(Seasonally Adjusted)



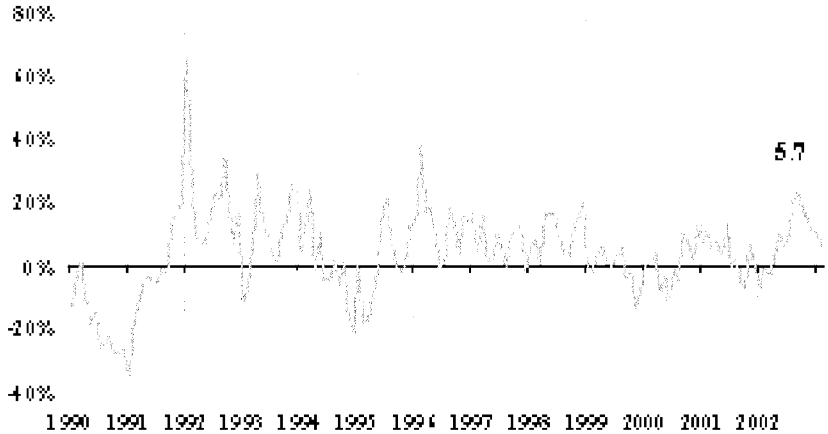
Source: U.S. Department of Labor and The Conference Board

One of the few sectors of the economy that has been adding jobs has been the residential housing real estate finance sector. Mortgage bankers and brokers have added over 120,000 jobs since January of 2001 during which time the U.S. economy has suffered a net loss of 2,531,000 private nonfarm jobs. Record low interest rates have provided an impetus that has allowed the housing sector to stand as one of the most important supports for the overall economy, softening the recession and serving as an engine to support the modest recovery to this point.

Home sales have set records each of the last two years at 6.19 million new and existing homes sold in 2001 and 6.58 million in 2002.

New Home Sales

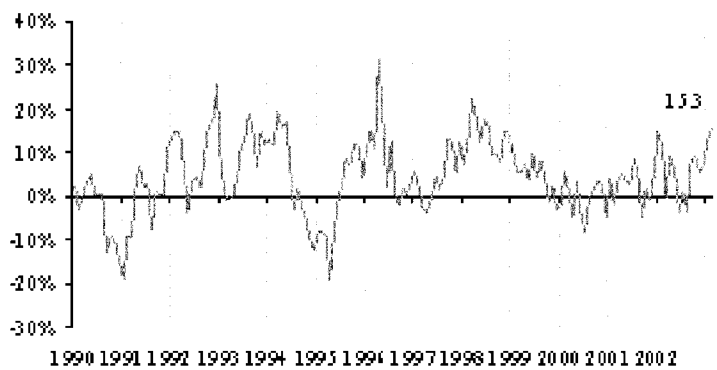
(Year/Year, Percent Change by Month)



Source: Census Bureau

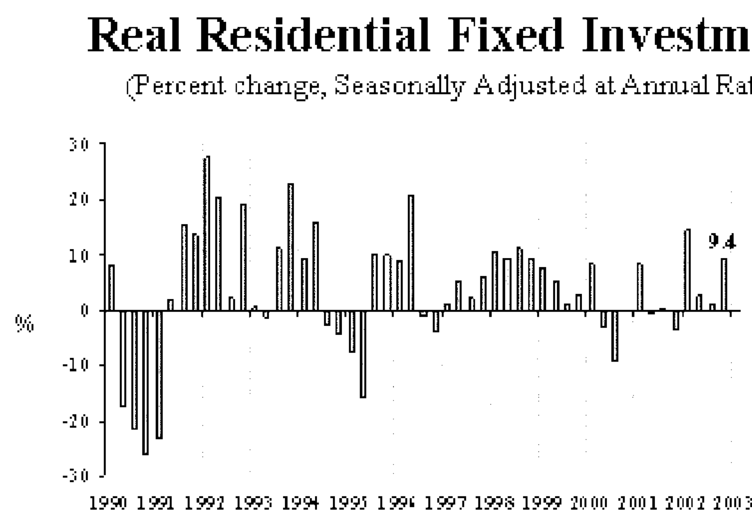
Existing Home Sales

(Year/Year, Percent Change by Month)



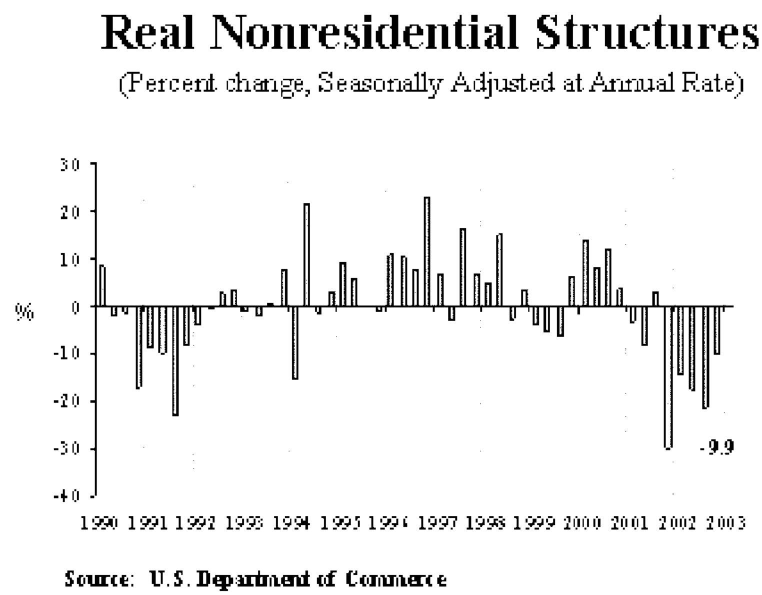
Source: National Associations of Realtors

Real residential fixed investment has remained strong throughout the current recessionary period, in contrast to the 1990–91 recession, providing valuable support to economic activity through sustained employment and materials demand in the residential construction sector as well.



Source: U.S. Department of Commerce

Unfortunately, the economic downturn and its effects on business fixed investment and employment have devastated the real nonresidential or commercial structures sector.

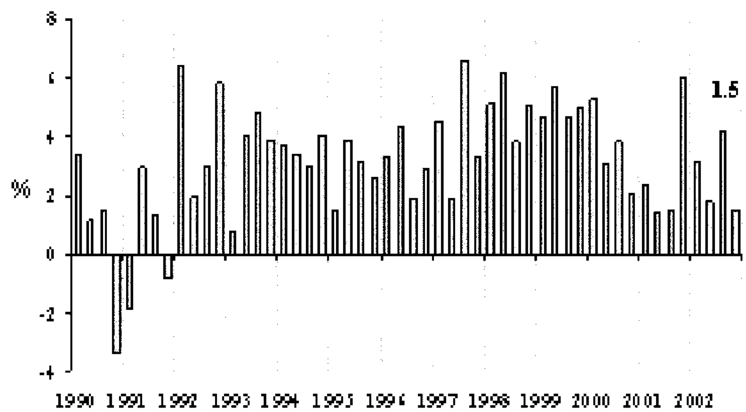


This sector will not return to health until such time as economic growth resumes at a higher level and employment picks up.

Concurrent with home sales increases, residential mortgage originations registered $2.03 trillion in 2001 and $2.46 trillion in 2002, both record levels. A significant part of the origination dollar amount was the removal of equity built up by increases in home values. The Federal Reserve estimates that roughly $200 billion of equity was extracted through "cash-out" refinancing in 2002, slightly higher than that of 2001. Of this cash, a substantial portion was applied to the reduction of other forms of debt but the remainder, perhaps as much as $75 billion each year was used for consumption of various kinds by households. Once again the housing sector provided support for the economy at a level well above that of the 1990–91 recession.

Real Personal Consumption Expenditures

(Percent change, Seasonally Adjusted at Annual Rate)



Source: U.S. Department of Commerce

The role of residential housing as a support for the economy through both the cash-out refinancing supporting consumer spending and through the consumption boost generated by the sale and financing of new and existing homes is expected to wane slightly in 2003. Refinancings, in particular, will recede from the historic levels of the last few years as the number of households for which there is an economic benefit declines. The housing sector will still be a strong leg for the economy but more in its traditional role of providing between 12 and 20 percent of GDP depending on how it is measured. However, as interest rates rise modestly and refinancing activity declines and provides somewhat less support for consumer spending and the economy, there will need to be an increase in income growth and employment to offset it.

The MBA's forecast for economic growth, employment and housing activity without the implementation of any sort of growth plan is for continued growth below capacity and little recovery in jobs until late 2004. Without a growth plan, we expect GDP growth in the neighborhood of 2.8 percent from fourth quarter to fourth quarter 2003 and 3.4 percent the following year. Furthermore, unemployment is expected to rise to a level of 6.1 percent and remain there through most of 2004. The housing sector is expected to begin a slow decline of modest proportions.

The Bush Administration has introduced a plan intended to boost employment and economic growth to provide the offset to the slowing housing sector. This will potentially be important to the housing industry as the three most important factors for a growing housing industry in the longer term are jobs growth, income growth, and demographic factors. Since the Bush Administration's plan is intended to increase both jobs and economic growth, it is incumbent on the Mortgage Bankers Association of America (MBA) to assess the plan's expected impact on the residential and commercial real estate and real estate finance industries. What follows is a description of the Administration's proposal's major elements and their estimated impacts on the economy and real estate finance.

MBA Analysis of the Bush Administration's Growth and Jobs Plan

The MBA has undertaken an analysis of the economic effect of the Bush Administration's proposed economic growth package. The MBA has determined that if the package were passed by the middle of 2003, 1.0 million new jobs would be created by the end of 2004, or within 18 months of the passage of the plan. The MBA esti-

mates that if the plan were passed in its entirety, Gross Domestic Product (GDP) would increase by an additional 0.5 percent during 2003 and by an additional 0.9 percent during 2004. As a result of this analysis, the MBA strongly recommends passage of the plan.

Key Points of the Bush Administration's Plan

The Bush Administration's plan has two key components, the acceleration to January 1, 2003 of the tax cuts passed in 2001 that are now being phased-in over several years, and an elimination of the double taxation of dividends. The proposed accelerated tax cuts include:

- The expansion of the 10 percent tax bracket.
- The reduction in the 27%, 30%, 35% and 38.6% income tax rates to 25%, 28%, 33% and 35% respectively.
- The reduction in the marriage penalty.
- An increase in the child tax credit from $600 to $1,000. In addition, the 2003 increase would be paid to qualifying taxpayers with advance payment checks in July 2003.

In addition to the elimination of the double taxation of dividends, the Administration proposes increasing from $25,000 to $75,000 the amount of investment that small businesses can expense immediately and increasing the Alternative Minimum Tax exemption by $8,000 for married taxpayers ($4,000 for single taxpayers) between 2003 and 2005.

Assumptions in Estimating the Effect of the Plan

Estimates of the effects of tax changes on economic growth are always challenging, particularly when we are looking at reversing the effects that the double taxation of dividends has created over many years. For example, the MBA estimates that the removal of the double taxation of dividends would add roughly $30 billion annually to after-tax incomes. Since there is little historical precedent on how much of this will result in additional spending, the MBA made the very conservative assumption that the amount of new spending would be small, and that the principal stimulative effect of the proposal would come from the resulting increase in equity prices. There appears to be little argument that some increase in stock prices would occur; the question is how large it would be. Estimates of private economists put the probable increase in the 5 to10 percent range. The MBA is assuming an increase of 7.5 percent in its model.

The experience of the late 1990s clearly indicates that increased wealth in the form of higher equity prices does encourage consumers to spend more and save less, as would be expected. Higher equity prices also reduce the cost of equity capital to businesses, potentially increasing business spending for capital equipment. There is thus good reason to expect positive benefits to economic growth from eliminating taxes on dividends. Indeed, since the weak and erratic nature of the economic recovery that began a year ago probably traces in good measure to the legacy of the bear market in equities, an upturn in stock prices should clearly help strengthen the economy.

The acceleration of the tax cuts should have a major, direct impact on consumer spending. Tax cuts that are permanent have a much larger impact on consumer spending than those that are temporary, such as rebates. Estimates from previous tax cuts are that individuals spend only about one-fifth of any funds received via temporary tax cuts or rebates. On the other hand, spending out of permanent tax cuts, such as those proposed in the Administration's plan, runs closer to two-thirds of the increase in disposable income.

One additional but minor point is whether the acceleration of previously scheduled tax cuts might have a slightly different impact on personal consumption than newly scheduled tax reductions. The issue with the accelerated tax cuts in the Administration's proposal is whether or not individuals have already increased their spending in anticipation of future tax cuts already enacted into law. While it is theoretically possible that consumers have already begun to spend part of expected future tax cuts, the MBA believes this is highly unlikely and that most consumers have not made the careful calculations that would be necessary to estimate how future tax changes would affect their after-tax income. Even if they had done so, they would probably still be uncertain as to whether future tax cuts would actually be realized, given the desires of some in Congress to cancel some or all of scheduled future tax cuts. In the estimates of the economic effects of the stimulus package discussed below, the accelerated tax cuts announced in the Administration's proposal are treated the same as if they were newly enacted tax reductions.

To estimate the impact on economic growth, simulations were done with the econometric model that the MBA uses for creating its economic forecasts, a model created by Macroeconomic Advisers of St. Louis. The MBA used the following assumptions:

- The new tax proposals are assumed to be passed in their proposed form by mid-year 2003 and go into effect during the third quarter.
- Stock prices are assumed to increase 7½ percent in response to the elimination of taxes on dividends.
- The tax cuts result in a $70 billion increase in income to taxpayers.

MBA Simulation Results

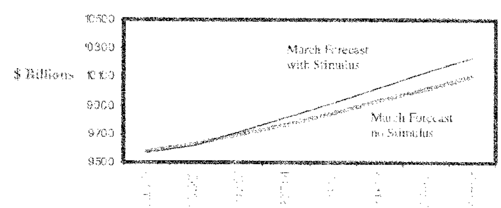
Impact on GDP and Employment

The results provide general confirmation of the Administration's estimates of the near term impact on economic growth. Regarding GDP growth and employment, the simulations suggest the following.

The simulations suggest that 0.5 percent would be added to GDP growth in the last two quarters of 2003, measured year-over-year, and 0.9 percent added to year-over-year growth in 2004.

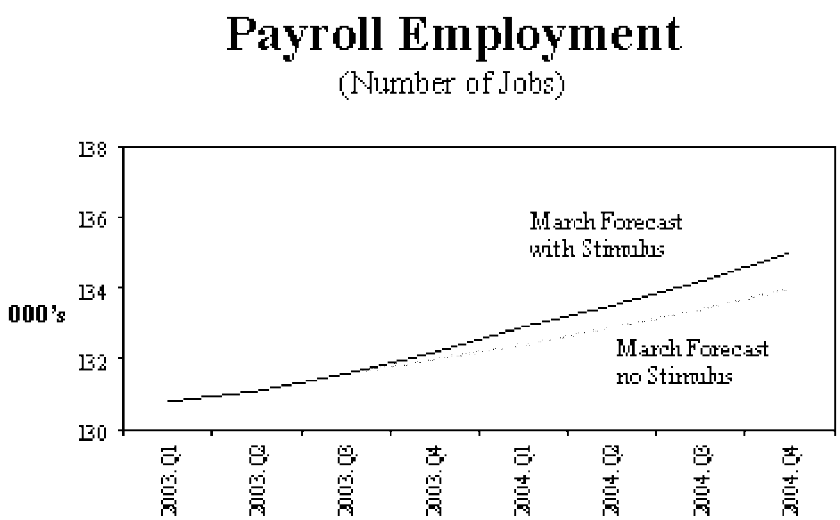
Real GDP

(Billions, Annual Rate)



Source: MBA

By the fourth quarter of 2004, the number of payroll jobs would be boosted by 1.0 million.



Source: MBA

The MBA's current forecast for annualized growth in the latter half of this year is in the 3 to 3¼ percent range. The simulations suggest that annualized growth during the third and fourth quarters might be boosted by as much as a full percentage point, raising the growth rate during that period to 4 to 4¼ percent.

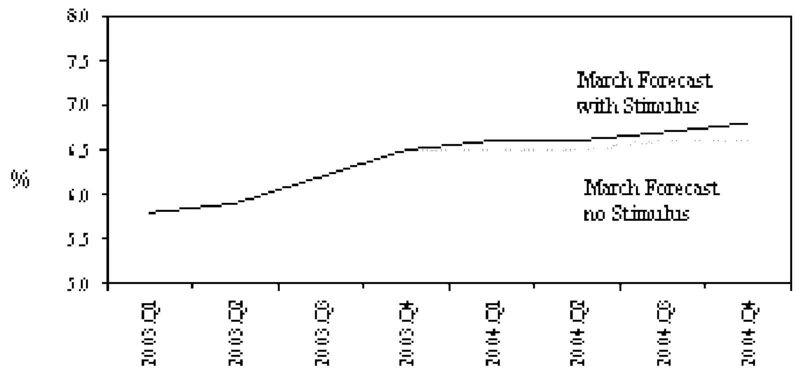
Impact on Interest Rates

The MBA's estimate of the impact of the Administration's growth package suggests a bit less growth coming from the stimulus package than what the Administration estimates—though the difference is quite small. One possible reason for the difference could be differences in the allowances made for the impact of the stimulus package on interest rates.

Several factors would likely increase interest rates with any stimulus package. First, the demand for funds is likely to increase with any economic recovery, putting upward pressure on rates. Second, if equity prices are boosted, a substantial part of the money flowing into equities might come from investments in fixed income securities, pushing up their yields. Both of these effects would be offset somewhat if the result of elimination of the double taxation of dividends is to make equity funding less expensive and reduce somewhat the corporate demand for debt funding.

How large an effect on interest rates would occur depends importantly on how the Federal Reserve reacts to the impact of the stimulus package on the economy. Given the currently very low rate of inflation, it is MBA's judgement that the Fed would not rush to raise interest rates at the first sign of improved economic growth. From the middle of this year onward, however, the economy could well be growing at a pace that reduces unemployment significantly. The real federal funds rate is now below zero (meaning that the rate is below the rate of inflation), implying a posture of monetary policy that cannot be sustained indefinitely. Solid economic growth would give the Fed the opportunity to move gradually back toward a neutral posture. The simulations allow for this, but suggest that the increase in interest rates would be quite moderate, in the neighborhood of 20 basis points above what they otherwise would have been on the 30-year fixed rate mortgage rate by year-end 2004.

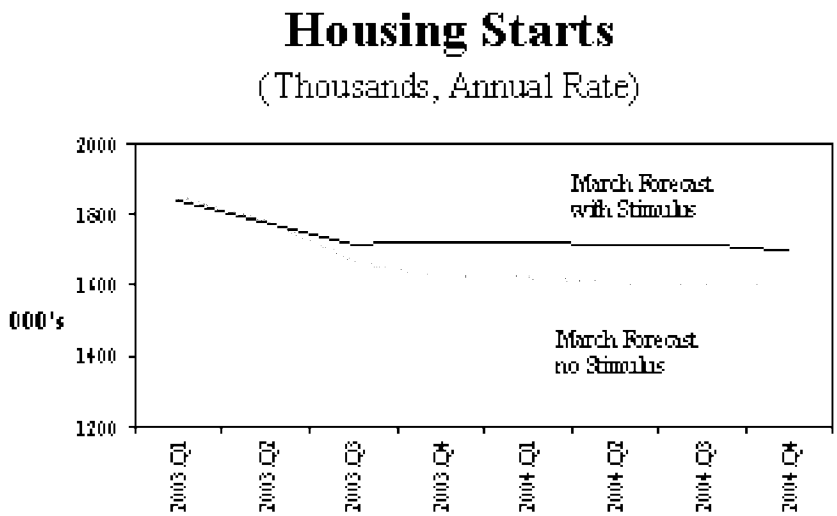
Conventional 30-Year Mortgage Rate



Source: MBA

Impact on Housing Starts

The effect of the Administration's proposal on housing starts is to increase them. The increase in employment (which is significant but not so large as to put upward pressure on the price level) and disposable income overrides the minor increase in interest rates. The result is that housing starts are increased by 30,000 units in 2003 and by 100,000 units in 2004 through implementation of the full plan.



Source: MBA

Were the dividends exclusion component of the plan not enacted, the impact on 2003 starts would be a smaller increase of 25,000 units and starts in 2004 would be 60,000 higher rather than 100,000 with the full plan.

Conclusion

The halting and weak nature of the current economic recovery and the related lack of job creation have led to the proposal that fiscal policy be used to encourage greater economic growth. The Bush Administration has proposed a defined package of policies for the purpose of increasing economic growth and accelerating job creation. The two main elements of the Administration's plan are the acceleration and making permanent of the previously enacted marginal tax rate cuts and the elimination of the double taxation of corporate dividends.

The MBA incorporated the combined package into a simulation of economic activity for purposes of evaluating the capacity of the proposal to increase job formation and income growth in the next two years, a period of time over which the full effects should play out. Simulation results produced by MBA, and based on conservative assumptions, show that the effects predicted by the Bush Administration's economic advisors are supported, with any differences within the tolerances of such models. Our estimates anticipate an annualized increase of 0.9 percent in GDP growth by year-end 2004 and the addition of 1.0 million additional jobs in that same time frame. The plan will have a minimal impact on mortgage interest rates and will generate an additional 130,000 housing starts over the simulation time frame.

As a result of the estimated positive effects on the economy and the related benefits for the commercial and residential real estate sectors, MBA is strongly recommending the adoption and implementation of the plan as soon as possible.

Appendix 1

Other Benefits of the Bush Administration's Proposal for the Elimination of the Double Taxation on Dividends

In addition to the direct economic benefits of the Administration's growth plan discussed in the report, the MBA sees a number of other advantages to improved corporate governance and operations that will ultimately inure to the benefit of the

economy by increasing investor confidence and increasing capital market efficiencies.

1. Greater corporate transparency. By removing the tax disincentive not to pay dividends, corporations will be under greater pressure to justify their levels of retained earnings. The justification for retaining funds in a corporation is that the firm has better growth and investment prospects than the individual investor, particularly on an after-tax basis. Once the double taxation of dividends is removed, firms will have to be more open about their investment prospects that justify not paying out dividends.
2. Dividends will be a greater reality check on earnings. Some of the largest corporate collapses in the last two years came as a result of inflated earnings and cash needs supported by increasing levels of debt. Putting a greater emphasis on cash payouts in the form of dividends will serve as a reality check on reported earnings.
3. Lower leverage levels will tend to make corporate balance sheets less fragile. Removing the double taxation of dividends should make equity financing relatively cheaper to debt financing than is currently the case. By encouraging corporations to have less debt financing, aggregate corporate balance sheets would become less fragile.
4. Reduce the need to sell stocks for current income. The double taxation of dividends has discouraged firms from paying dividends to shareholders. While individuals in need of regular cash income from their stocks have generally concentrated their purchases on higher dividend-paying stocks, others are placed in the position of having to sell their stocks and buy replacements in order to capture the same income in the form of capital gains but at a lower tax rate. The Administration's proposal to reduce the volume of stock sales that occur solely to generate regular income at capital gains rates.

Appendix 2

Analysis of the Impact of the Bush Administration's Economic Growth Plan on Low Income Housing Tax Credits

The MBA fully supports the Bush Administration's economic proposal. Some concerns have been raised, however, about the potential impact of the plan on one of the important and successful methods of promoting the development of rental apartments for lower income individuals, the Low Income Housing Tax Credit (LIHTC) program. The reason for the concern is inherent in the mathematics of the calculation of the Excludable Dividend Amount, or the amount of dividends that can be paid tax free to shareholders. The excludable amount is based on the amount of taxes paid by the corporation in the following fashion:

Excludable Dividend Amount = (Federal Tax Paid .35) − Federal Tax Paid

This can be restated as:

Excludable Dividend Amount = $1.85 \times$ Federal Tax Paid

The result is a situation where the amount of tax-free dividends that a corporation can pay is reduced by $1.85 for every dollar reduction in federal tax paid. The issue for LIHTCs then is whether the benefits of LIHTC investing at the corporate level are sufficient to offset any potential negative effects at the shareholder level, given that savings at the corporate level come at the corporate tax rate whereas the potential additional tax exposure is at generally lower individual income and capital gains rates. The MBA's analysis is that, under a range of reasonable assumptions regarding tax rates and dividend payout rates, marginal returns to shareholders from corporate investments in LIHTCs remain positive under the Administration's plan. While the marginal shareholder returns from LIHTCs are somewhat lower under the Bush Administration's plan than current law, the differences are driven entirely by assumptions regarding the tax effects of relative changes in capital gains tax basis. Since neither corporate yields nor the amount of tax-free dividends that can be paid are affected by LIHTC investments, under reasonable dividend payout assumptions, it is difficult to predict the degree of any negative pricing impacts. Based on all of the various and sometimes offsetting factors at work, it appears unlikely, that any negative price changes resulting directly from the Administration's plan would be significant. Indeed, it can be argued that a failure to pass the Administration's growth plan would negatively impact LIHTC prices. A danger to LIHTC pricing is a continued softness in current corporate earnings, combined with a negative outlook for the future. This could result in a reduced appetite for new LIHTC

investments and increased secondary market sales of existing credits, both of which would depress LIHTC prices.

In its analysis of the impact of the Administration's economic growth proposal on the LIHTC program, the MBA attempted to answer three questions. First, will LIHTCs remain viable investments, that is, will the tax costs to shareholders outweigh the benefits at the corporate level? Second, will prices be affected and to what degree? Third, if any adverse effects of the tax plan are large enough that they need to be mitigated, what form should changes to the plan take?

Will LIHTCs remain viable under the Bush Administration's jobs and growth plan?

The LIHTC program provides benefits at the corporate and shareholder level. While the exact returns will differ based on a broad continuum of corporate and individual income and capital gains tax rates, attached Exhibit 1 shows the marginal benefit of a LIHTC priced to yield 8 percent in the form of tax credits under current law. The assumptions in the model assume that the effective corporate tax rate is 28 percent, the dividend payout rate is 48 percent of after-tax earnings, the marginal individual income tax rate on dividends is 35 percent, and the individual capital gains tax rate is 10 percent. These average tax and dividend payout rate assumptions are reasonable averages of average rates and were used in a recent study on this issue by Ernst & Young. In this particular example, the marginal benefit at the corporate level is $367 and the benefit passed through to shareholders is $287. It is important to note that this benefit is highly dependent on effective tax rates. For example, were it assumed that the effective corporate tax rate is 35 percent, the benefit would jump by 19 percent to $437, of which $341 would be passed on to shareholders. It is reasonable to assume that corporations with higher effective tax rates would be willing to pay more for LIHTCs than those in lower tax brackets. Therefore, any assumptions regarding the pricing impact of the Administration's tax proposal must take into consideration the effective tax rates of the purchasers of LIHTCs, not the average of all corporations.

Exhibit 2 uses an identical set of tax rate and dividend assumptions to show the marginal benefit of investing in LIHTCs under the Administration's growth package. What is important is that the benefit remains positive overall to shareholders, and, assuming a constant dividend payout ratio, the LIHTC investment *increases* the amount of tax-free dividends they receive. In addition, the marginal return to shareholders increases by 65 percent if it assumed that companies investing in LIHTCs are those with effective federal tax rates of 35 percent. While the size of the marginal benefit is lower under the Administration's proposal, that reduction is entirely in the change in capital gains basis where the applicable rate assumptions are the most open to question.

The purpose of Exhibit 3 is to put the LIHTC issue into some sort of context with the total impact on shareholder returns. While the relative magnitude of the change in returns is based on the relative size of the LIHTC investment, here it is assumed, as in the previous exhibits, that LIHTC investments are 1 percent of a corporation's pre-tax net income. The overall benefits to shareholders from the Administration's package dwarf the marginal shareholder effects from LIHTC investments, increasing returns by 24 percent both with and without LIHTCs.

What will be the impact on LIHTC prices?

Absent a detailed analysis of the price elasticities of the demand and supply in the LIHTC market, it is impossible to develop a firm analysis of the impact a change in the relative value of LIHTCs under the Administration's plan would have on LIHTC pricing. It would be clearly incorrect simply to establish some baseline hurdle rate and estimate how much LIHTC prices would have to adjust to meet that particular hurdle rate for a set of investors with a particular set of tax and dividend expectations. Given the various reasons for investing in LIHTCs, including CRA considerations, it may be sufficient for some investors to know only that returns do not turn negative for them to continue their investments.

There are a number of factors that influence LIHTC pricing. First, given the long duration of the LIHTC investment commitment (10 years), prices are driven by changes in discount rates, which in turn are driven by changes in underlying interest rates and changes in relative risk. The extent to which interest rates have fallen over the last 18 months has helped support LIHTC prices.

Second, it is not clear the extent to which any corporation can base an investment decision on the tax situation of a particular class of investors. For example, corporations have long paid dividends despite the fact that, for some investors, dividends are taxed at a higher rate than capital gains. If after-tax returns to shareholders in the examples used to discuss the potential impact of the Administration's plan

on LIHTCs are really a primary motivator, one would have to question why any corporations ever pay any dividends. It should be noted that for shares held in pension funds or 401k accounts where the applicable dividend and capital gains rates are zero, there is no reduction in the marginal shareholder return from LIHTCs.

Third, LIHTC prices are fundamentally driven by supply and demand. In a report for the Millennial Housing Commission, Recapitalization Advisors, Inc. gave a history of LIHTC prices since the inception of the program, and demonstrated how prices improved as the program matured:

Years	Average prices (per dollar)
1987–1989	.45
1989–1993	.52
1993–1997	.65
1998–2000	.74
2001–	.77

In addition to noting the steady increase in LIHTC prices, Recapitalization Advisors notes that at one point in early 2001, LIHTC prices dropped by 10 percent in as little as three months as a result of an apparent 40 percent increase in the supply of LIHTCs hitting the market at one time. Other negative impacts on prices mentioned in the Recapitalization Advisors report include whether the strongest properties have already been financed and the potential overhang of the now sizable secondary market for trading these tax credits.

The point is that LIHTC prices can be volatile absent changes in tax laws, and that any and all effects on supply and demand resulting from the passage of the Administration's growth plan must be taken into consideration. It can be argued, for example, that if the economy did not improve, the profits and therefore the tax credit appetites of traditional LIHTC investors would go down. Not only would these firms drop out of the primary market for LIHTCs, they would likely seek to sell their existing credits in the secondary market, further depressing prices. Thus depressed corporate earnings from a sluggish economy could pose the greater risk to LIHTC pricing, particularly since LIHTC shareholder returns remain positive under the proposal and firms will thus not have an incentive to dump their credits on the secondary market.

If any adverse effects on the LIHTC program need to be mitigated, what form should changes in the Bush Administration's growth proposal take?

If it becomes clear that the Administration's growth proposal will have significant negative effects on LIHTC prices due to the relative change in shareholder returns, what form should any change take? Since dividend returns to shareholders are not negatively affected under any reasonable assumptions of dividend payout ratios, there appears to be no need to change the fundamental calculation of Excludable Dividend Account. Instead, because it appears that any potential negative effects would be due solely to the change in capital gains basis and potential additional capital gains taxes, any remedy should be aimed at that issue. The problem would be largely ameliorated by allowing the capital gains tax basis to be increased either by the amount of the LIHTC tax credit or the amount of the LIHTC investment expensed by the investor, or lowering capital gains tax rates.

Conclusion

While it appears that the relative benefits of LIHTC investments may decline for some investors under the Administration's proposal, it is unclear what the effect on LIHTC prices might be. Given that the effect of the proposal on shareholder returns is limited to the changes in capital gains basis, the proposal may have limited effect. Indeed, not enacting the plan may have a greater effect on LIHTC pricing if the demand for LIHTC investments declines with lower corporate profits.

In any event, any potential impact on LIHTCs is not a reason to oppose the growth plan but, if necessary, to seek changes to limit any negative effects. It ap-

pears that adjusting the capital gains basis to reflect LIHTC investments would be sufficient to offset the capital gains impacts on relative shareholder returns.

EXHIBIT 1

LIHTC Benefits Under Current Law			
	Without LIHTC investment	With LIHTC investment	Marginal Benefit of LIHTC
At Corporate Level:			
Net Income	100,000	100,000	0
LIHTC cost	0	1,000	1,000
Taxable Income	100,000	99,000	(1,000)
Corp Inc. Tax before LIHTC	28,000	27,720	(280)
LIHTC Credit	0	1,087	1,087
Corp. Inc. Tax After LIHTC	28,000	26,633	(1,367)
Net after tax earnings	72,000	72,367	367
At Shareholder Level:			
memo: Excludable Dividend Amount	0	0	0
Dividends received:	34,200	34,374	174
Shareholder taxable dividends	34,200	34,374	174
Shareholder dividend tax	11,970	12,031	61
Shareholder after-tax dividends	22,230	22,343	113
Capital gains change from retained earnings	37,800	37,993	193
Retained earnings benefit adjustment	0	0	0
Taxable capital gains	37,800	37,993	193
Future capital gains tax	3,780	3,799	19
Shareholder after-tax capital gains	34,020	34,193	173
After-tax return to shareholders	56,250	56,537	287

EXHIBIT 1—Continued

LIHTC Benefits Under Current Law			
	Without LIHTC investment	With LIHTC investment	Marginal Benefit of LIHTC
Assumptions:			
Corporate Marginal Tax Rate:	35%		
Corporate Effective Tax rate:	28%		
LIHTC Annual Yield	8%		
Dividend payout ratio	48%		
Individual income tax rate	35%		
Individual capital gains tax rate:	10%		

EXHIBIT 2

LIHTC Benefits Under Proposed Law			
	Without LIHTC investment	With LIHTC investment	Marginal Benefit of LIHTC
At Corporate Level:			
Net Income	100,000	100,000	0
LIHTC cost	0	1,000	1,000
Taxable Income	100,000	99,000	(1,000)
Corp Inc. Tax before LIHTC	28,000	27,720	(280)
LIHTC Credit	0	1,087	1,087
Corp. Inc. Tax After LIHTC	28,000	26,633	(1,367)
Net after tax earnings	72,000	72,367	367
At Shareholder Level:			
memo: Excludable Dividend Amount	52,000	49,461	(2,539)
Dividends received:	34,200	34,374	174
Shareholder taxable dividends	0	0	0

EXHIBIT 2—Continued

LIHTC Benefits Under Proposed Law			
	Without LIHTC investment	With LIHTC investment	Marginal Benefit of LIHTC
Shareholder dividend tax	0	0	0
Shareholder after-tax dividends	34,200	34,374	174
Capital gains change from retained earnings	37,800	37,993	193
Retained earnings benefit adjustment	17,800	15,087	(2,713)
Taxable capital gains	20,000	22,906	2,906
Future capital gains tax	2,000	2,291	291
Shareholder after-tax capital gains	35,800	35,702	(98)
After-tax return to shareholders	70,000	70,076	76
Assumptions:			
Corporate Marginal Tax Rate:	35%		
Corporate Effective Tax rate:	28%		
LIHTC Annual Yield	8%		
Dividend payout ratio	48%		
Individual income tax rate	35%		
Individual capital gains tax rate:	10%		

EXHIBIT 3

Comparative Gains under Proposed Law						
	Without LIHTC, Current Law	Without LIHTC, Proposed Law	Gains	With LIHTC, Current Law	With LIHTC, Proposed Law	Gains
At Corporate Level:						
Net Income	100,000	100,000	0	100,000	100,000	0
LIHTC cost	0	0	0	1,000	1,000	0
Taxable Income	100,000	100,000	0	99,000	99,000	0
Corp Inc. Tax before LIHTC	28,000	28,000	0	27,720	27,720	0
LIHTC Credit	0	0	0	1,087	1,087	0
Corp. Inc. Tax After LIHTC	28,000	28,000	0	26,633	26,633	0
Net after tax earnings	72,000	72,000	0	72,367	72,367	0
At Shareholder Level:						
memo: Excludable Dividend Amount	0	52,000	52,000	0	49,461	49,461
Dividends received:	34,200	34,200	0	34,374	34,374	0
Shareholder taxable dividends	34,200	0	(34,200)	34,374	0	(34,374)
Shareholder dividend tax	11,970	0	(11,970)	12,031	0	(12,031)
Shareholder after-tax dividends	22,230	34,200	11,970	22,343	34,374	12,031
Capital gains change from retained earnings	37,800	37,800	0	37,993	37,993	0

Retained earnings benefit adjustment	0	17,800	17,800	0	15,087	15,087
Taxable capital gains	37,800	20,000	(17,800)	37,993	22,906	(15,087)
Future capital gains tax	3,780	2,000	(1,780)	3,799	2,291	(1,509)
Shareholder after-tax capital gains	34,020	35,800	1,780	34,193	35,702	1,509
After-tax return to shareholders	56,250	70,000	13,750	56,537	70,076	13,540
Percentage increase:			24%			24%
Assumptions:						
Corporate Marginal Tax Rate:	35%					
Corporate Effective Tax rate:	28%					
LIHTC Annual Yield	8%					
Dividend payout ratio	48%					
Individual income tax rate	35%					
Individual capital gains tax rate:	10%					

National Advocacy Center of the Sisters of Good Shepherd
Silver Spring, Maryland 20904–3300
February 27, 2003

The Honorable Bill Thomas
Chairman, Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Charles Rangel
Ranking Member, Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Re: President Bush's "Economic Growth" Proposals

Dear Chairman Thomas and Ranking Member Rangel,

The National Advocacy Center of the Sisters of the Good Shepherd, representing sisters and programs in 22 states and the District of Columbia, appreciates this opportunity to share our views regarding the President's "economic growth" proposals. Our concerns reflect the commitments of the Sisters of the Good Shepherd and Good Shepherd programs to addressing the needs of low-income and vulnerable families and children and to structural change that promotes social justice.

The National Advocacy Center of the Sisters of the Good Shepherd opposes the "economic growth" proposals put forward by President Bush. These proposals would not only fail to stimulate the economy, but are also fundamentally unfair as the majority of the benefits will go to the wealthiest Americans and not to those most in need of assistance during this economic downturn. Moreover, the President's proposals would drain additional funds from state budgets even as they face record deficits and would undermine long-term fiscal responsibility, crippling our efforts to make crucial investments in our economy and our people.

Sisters of the Good Shepherd and Good Shepherd programs work directly with low-income and vulnerable families on a daily basis. These families are the hardest hit in times of recession and their current situation is made even worse by the cuts states are making in child care, health care, education, and other services due to budget shortfalls. Directing assistance to these families is not only the just thing to do, but would also be an immediate way to inject money into the economy and increase demand for goods and services because these families are most likely to spend whatever assistance they receive. Yet, the President's proposals offer little help to these families.

According to the Urban Institute-Brookings Institution Tax Policy Center, nearly 11 million families with children, those making $20,000 or less per year—or one-fourth of all families with children—would receive no benefits from the tax cuts proposed by the President. The average tax cut for the bottom 80% of taxpayers would be just $239. In contrast, those with incomes over $1 million would receive an average tax cut of $88,900, little of which would be directed back into the economy in the short term to provide the needed stimulus. At the same time, the proposal to eliminate taxation on dividend income would drain another $4 billion or more from state budgets forcing further cuts in social programs that are essential to the economic stability of many working families. In addition, the loss of revenue and long-term costs of the President's proposals will increase the federal deficit and jeopardize funding for critical priorities in the short and long term. Already cuts have been proposed for low-income housing, job training, after school programs, and other services to vulnerable families.

Catholic Social Teaching states that economic decisions must be at the service of all people, especially the poor. In this light, a good economic stimulus plan should minimize the economic hardship that many, especially low-income workers, are experiencing by targeting unmet needs, providing assistance to prevent programs cuts at the state level, and promoting fiscal responsibility to ensure that adequate resources are available for human needs programs. President Bush's "economic growth" proposals fail to meet any of these criteria; therefore, the National Advocacy Center opposes them and urges the House Committee on Ways and Means to reject them and develop an alternative based on the criteria outlined above.

Thank you again for this opportunity to share our concerns.

Sincerely,

Sr. Brigid Lawlor, RGS, JD
National Coordinator

Alison L. Prevost
Lobbyist

Statement of the National Association for the Self-Employed

As proposals for stimulating the nation's sagging economy are debated, the **National Association for the Self-Employed (NASE)** and our 250,000 members businesses, representing over 600,000 employers and employees and self-employed individuals, would like to clearly convey that significant reforms to revitalize our nation's micro-businesses, the lifeblood of America's economy, must be included in an economic stimulus plan in order to jump start our ailing economy.

The historic economic contribution of micro-businesses cannot be overstated in this dialogue. Today, this segment represents more than 18 million self-employed individuals and owners of micro-business firms that—in the past few decades in particular—have leveraged size, flexibility and entrepreneurship to ignite what has arguably been the most remarkable era of innovation and growth in our nation's history. In fact, firms with fewer than 10 employees created well over a third of all new jobs to the economy between 1998 and 1999, and the last U.S. Census reported that these firms employ more than 12.3 million workers with a total annual payroll of more than $309.7 billion.

Beyond these tangible contributions, it's also important to note that in a period marked by corporate scandals and uncertainty, "Main Street" businesses remain a bright example of solid American virtues and values. According to a recent poll by USA TODAY, CNN and Gallup, Americans rate people who own small businesses as the second most trustworthy group in the nation, right behind teachers.

The NASE is pleased to see income tax rate reductions and an increase in business equipment expensing in the forefront of many of the stimulus proposals. However, we firmly believe that these plans do no go far enough in addressing some of the key issues that create a drag on growth for the self-employed and micro-businesses. In working with many of the nation's self-employed, I see several key issues and measures that are critical to getting micro-businesses back in position to help revive the economy. The NASE proposes a Micro-Business Stimulus Plan, which includes:

- An Increase in Business Expensing
- Clarification of Independent Contractor Status
- Payroll Tax Relief
- Home-Based Business Deduction Simplification
- Self-Employment Tax Deduction on Health Insurance Premiums
- Health Care Tax Credits

Increase in Business Equipment Expensing

The NASE proposes an increase of the deductible for business equipment expenses. Section 179 of the Internal Revenue Code should be amended to increase the amount of equipment purchases that small businesses may expense each year from the current $25,000 to $40,000. This change will eliminate the burdensome record keeping involved in depreciating such equipment and free up capital for small businesses to grow and create jobs. Also increases the phase-out limitation for equipment expensing from the current $200,000 to $400,000, thereby expanding the type of equipment that can qualify for expensing treatment. This limitation along with the annual expensing amount should be indexed for inflation in any proposed legislation.

Section 179 should also be amended to permit expensing in the year that the property is purchased or the year that the property is placed in service, whichever is earlier. This will eliminate the difficulty that many small firms have encountered when investing in new equipment in one tax year (e.g., 2001) that cannot be placed in service until the following year (e.g., 2002).

Independent Contractor Status Clarification

The IRS' lack of clarity in defining "independent contractor" versus "employee" for tax purposes has presented major difficulties for micro-business owners, costing owners more than $750 million in IRS fines and back-taxes over the past 10 years. The NASE proposes that legislation for a micro-business stimulus package include all the provisions of the Independent Contractor Determination Act of 2001 (S. 837, H.R. 1783) previously introduced in the 107th Congress.

Key provisions would create new worker-classification rules and would prohibit the IRS from reclassifying independent contractors as employees if employers have a reasonable basis for its treatment of workers as independent contractors.

One-time Payroll Tax Cut

Currently, the payroll tax is 12.4% for Social Security and 2.9% for Medicare, for a total of 15.3%, divided equally between employee and employer. Four of five taxpayers now pay more in payroll taxes than income taxes. Some taxpayers do not necessarily realize it because their employers pay half of the payroll tax. However, the self-employed are required to pay both the employer and employee share of payroll taxes, leaving them with a continuously increasing tax burden. The Congressional Budget Office has estimated that the 10% of taxpayers making $100,000 or more this year will pay 64% of all income taxes and 31% of payroll taxes. By contrast, the 62% of households earning $50,000 or less will pay just 7% of income taxes but 30% of payroll taxes.

A payroll tax cut would give the economy a powerful shot in the arm because the benefits are spread so widely. The NASE proposes a refund to employees and employers in micro-businesses with 10 or less employees, also including the self-employed, on the payroll taxes they paid in 2001 on the first $10,000 of each employee's or self-employed individual's earnings.

Home Office Tax Deduction Simplification

With the rise in home-based businesses, tax deductions for home offices are an important benefit for self-employed individuals and micro-businesses. The NASE proposes a new $2,500 tax deduction for home-based small-business operators, which will greatly simplify their tax filing process. This amount represents the average amount taken by home office tax filers each year. Additionally, legislation should repeal tax code provisions that require homeowners to "recapture" their depreciation when they sell their homes. These current tax provisions prevent home based business owners from taking full advantage of capital gains tax exclusions, which exempt $250,000 ($500,000 for married couples) on the gain of the sale of a primary residence.

Self-Employment Tax Relief on Health Insurance Premiums

Current tax codes related to health insurance premiums deliver another whammy that is unique to the self-employed. Under present tax laws, corporations are able to deduct health insurance premiums as a business expense and to forego FICA (Social Security and Medicare) taxes. In contrast, the self-employed are not allowed to deduct premiums as a business expense and thus, are required to pay an additional 15.3 percent self-employment tax on these expenses. These additional costs are a chief reason why the working self-employed and their families comprise 62 percent of the 43 million Americans who are without health insurance.

Scheduled to phase in this year is 100% deductibility of health insurance premiums for the self-employed. However, this does not solve the tax inequity. One hundred percent (100%) deductibility of health insurance premiums for the self-employed relates to income tax and not self-employment tax. The self-employed are required to pay two types of taxes on their returns: income tax and self-employment tax.

The current inequity in the Internal Revenue Code as it relates to the self-employed and their health insurance premiums must be corrected. To achieve tax equity between all forms of business entities, the self-employed must receive exclusion of health insurance premiums from self-employment tax regardless of the entity form under which they choose to operate. The NASE proposes the following options to achieve equity:

1. Internal Revenue Code Sec. 162(l)(4) Code Sec. 1402(a) currently excludes the self-employed health insurance deduction from net earnings from self-employment. If these code sections were eliminated then health insurance premiums would be a deduction for purposes of computing the self-employment tax while leaving the self-employed deduction for insurance premiums as an above the

line deduction on Form 1040. Alternatively, a line item deduction for the same amount as the self-employed insurance deduction on page 1 of 1040 could be added to Schedule SE.

2. Health insurance premiums of the self-employed could be deductible on Schedule C or E as an ordinary and necessary business expense rather than the deduction above the line on Form 1040.
3. The group health insurance benefit provisions of the Internal Revenue Code could be expanded to include individuals who have "earned income" and/or the provisions of IRC Section 105 (medical reimbursement plans) could be expanded to include self-employed owners. This change would have the effect of making the insurance premiums deductible at the entity level (Schedule C, Form 1065 or Form 1120S) thus eliminating the need for the self-employed insurance deduction on page 1 of 1040 or on Schedule SE.

Health Care Tax Credits

With eight out of ten uninsured Americans in working families, our nation stands in desperate need of strategies to address the needs of the working uninsured. One place to start is in the micro-business and self-employed communities. Almost 100% of large firms offer health insurance. But for small employers, that number is cut in half and the self-employed continue to find it a daunting task to gain access to affordable health coverage.

The NASE proposes that micro-businesses (C corporations) with ten or less employees receive a 50% tax credit, up to $2000 per individual policy, and $5000 per family, for purchasing health coverage for themselves and their employees. Sole-proprietors (Schedule C filers) and partners in partnerships with earned income and 2% owners in S Corporations (Schedule E filers) should receive a pre-payable, fully refundable tax credit towards the purchase of health insurance. The credit would be $1,000 for individuals, $2,000 for married couples and $500 per dependent up to $3,000 per family, plus 50 percent of any additional premiums to assist those with higher costs.

Conclusion

Again, the NASE would like to restate our support for specific proposals in the Administration's economic growth plan. However, we feel more needs to be done to result in true growth of our waning economy. We also strongly feel that economic growth can only be spurred if the issue of access to affordable health coverage is addressed. Any infusion of funds received by growth provisions will go directly into alleviating micro-business owner's current health care burden rather than being reinvested in their business for the purposes of expansion and growth.

The NASE believes that micro-businesses and the self-employed have been pillars of innovation, integrity and reliability, fueling much of what is great about America. Finding solutions that provide a more equitable shake for these enterprises not only is in the best interest of this important segment of the small business population; it's in the best interests of our nation and its economy, as well.

Statement of the National Association of Home Builders

Thank you Mr. Chairman for the opportunity to present testimony to the Committee on Ways and Means on behalf of the National Association of Home Builders (NAHB). NAHB represents more than 205,000 members involved in home building, remodeling, multifamily construction, property management, subcontracting and light commercial construction. NAHB is affiliated with more than 800 state and local home builder associations around the country. Our builder members will construct approximately 80 percent of the more than 1.6 million new housing units projected for construction in 2003.

The home building industry has been one of the strongest contributors to the national economy in recent years. We have had record years of production that have led to the highest homeownership rate in U.S. history—67 percent. It is in America's interest to assure that the home building industry maintains its leadership role in the economy, not only because housing and related industries account for 14 percent of the gross national product (GDP), but most importantly because of the benefits of home ownership to our country.

The subject of these hearings, the "Economic Growth Package" in the Administration's FY 2004 budget, is a complicated proposal that affects a variety of issues of interest to the home building industry that warrant careful consideration and re-

view by the committee. In addition to stimulating increased consumption and capital investment, these issues include interest rates, rates of return on tax exempt bonds, possible effects on targeted tax credits such as the Low Income Housing Tax Credit, the proposed Homeownership Tax Credit, New Markets Tax Credit, and Historic Preservation Tax Credit.

First, I want to say that NAHB supports President Bush and the Congress in their efforts to achieve an economic stimulus package that will provide near term stimulus to consumer spending and capital investment, including more housing consumption and production. NAHB supports changes in the Bush Administration's tax proposal or any Congressional tax proposal that will avoid unintended consequences that would be harmful to the housing industry such as increasing interest rates or the rate of return on tax exempt bonds, or negatively impacting housing affordability by lessening the value of targeted tax credits such as the LIHTC, the President's proposed HOTC, the New Markets Tax Credit and the Historic Preservation Tax Credit.

NAHB specifically supports the primary short term stimulus elements of the "Economic Growth Package" that would accelerate the implementation of changes in the tax law scheduled to take place in the future and increase capital formation incentives for small businesses. The accelerated changes in the tax code are tax rate reductions, an expansion of the 10 percent rate bracket, providing marriage penalty relief, and increasing the child tax credit. The small business capital formation proposal would increase the amount small businesses can annually expense from $25,000 to $75,000. We do, however, have concerns with some aspects of the Economic Growth Package. We are concerned about the possible consequential effects of eliminating the double taxation of corporate earnings, as well as, the failure of the package to include a housing component.

The primary focus of my testimony today is focused on the impact of the Administration's proposal to eliminate the double taxation of corporate earnings on the LIHTC program. This is a complicated issue that requires some background information before it can be understood.

Background

Under present law, "C" corporations, generally large corporations with many shareholders, pay federal income tax on their earnings. After the tax is paid the corporations either pay dividends to shareholders from the earnings or retain the earnings in the corporation. When a shareholder receives a dividend payment from a corporation, the shareholder reports the dividend as taxable income on his or her personal tax return. If the corporation retains earnings, the shareholder does not receive a direct benefit for the retained earnings. However, the retained earnings may produce an indirect benefit of increasing the value of the corporation's stock because the corporation has more capital.

The distribution of a dividend from taxed corporate earnings to a shareholder who then pays tax on the dividend is a double taxation of the corporate earnings. This double taxation of corporate earnings affects how businesses conduct their financial affairs and can create economic distortions. Many businesses avoid organizing as "C" corporations. They operate as pass through entities, i.e., businesses that pass through their items of income and expenses to the owners who report the items on their individual tax returns. When businesses operate as pass through entities there is only one level of tax and the double taxation of corporate earnings is totally avoided. Pass through entities are generally Sub Chapter S corporations and different types of partnerships.

Corporations that cannot do business as a pass through entity can minimize the impact of the double tax on earnings in a number of ways. Corporations may avoid raising capital though stock offerings and instead raise capital with debt. Interest payments on the debt are fully deductible, and as a result, less costly than paying dividends. Corporations also can buy back stock. To shareholders that sell their stock, the gain is a capital gain that is usually taxed at the capital gains rate of 20 percent, rather than higher personal income tax rates. The shareholders that do not sell their stock also receive a benefit from corporate repurchases of outstanding shares. As the number of corporate shares in the market declines, the price of the remaining outstanding shares tends to increase. Corporations also may retain more earnings than they would otherwise to avoid having shareholders pay additional tax on the earnings. By retaining the earnings, the value of the stock may increase due to the additional capital that the corporation keeps, especially if the corporation profitably uses the retained earnings.

Another way corporations can reduce the impact of the double taxation of corporate earnings is to reduce their tax liability. Corporations today can increase their earnings by buying Low Income Housing Tax Credits (LIHTCs) that can offset a dol-

lar of tax liability with a dollar of tax credit. Corporations pay less for the credit than the amount of tax credit the corporation uses to offset its tax liability, producing a return on the transaction for the corporation. The increased earnings can be paid directly to shareholders as a dividend or retained in the corporation, indirectly benefiting the shareholders by increasing the corporation's capital. Today corporations make up approximately 98 percent of the market for LIHTCs. The large share of the market that corporations have is in part due to restrictions in the alternative minimum tax and on passive loss deductions applicable only to individuals. The LIHTC is considered a tax preference that is subject to AMT, which affects more and more taxpayers because the thresholds are not indexed. The passive loss rules limit the use of the LIHTC in offsetting the tax owed by individuals from non real estate investments.

The President's Proposal

The President's proposal to eliminate the double taxation of corporate earnings is accomplished in two ways. First, shareholders are entitled to exclude any dividend received from the taxable income they report on their personal tax returns that is attributable to taxed corporate earnings. The exclusion eliminates one of the two layers of tax that is currently imposed on corporate earnings. Second, shareholders are entitled to increase the cost basis of their stock by the amount of any retained corporate earnings that were subject to tax. The increase in the cost basis of the shareholder's stock reduces the amount of capital gains tax the taxpayer must pay if the stock is sold for more than its cost. This provision helps equalize the tax treatment of dividends and retained earnings in the proposal.

The president's proposal is expected to increase the amount of dividends paid because it will reduce the tax cost for the shareholders receiving the dividend. Since shareholders vote for the management of a corporation, corporate officers are expected to be compelled to increase dividend payments. The proposal also is expected to reduce the amount of capital raised with debt and increase the capital raised from stock issues because interest payments and dividend payments will be treated essentially the same. More businesses are expected to operate as C corporations than pass through entities because the adverse consequences of the double taxation of corporate earnings will be eliminated.

The relative beneficial changes to corporate earnings caused by the dividend proposal to other forms of investments will likely lead to a reduced rate of return on stocks because the amount received is not taxed. As a result, alternative forms of investment will likely experience a required increase in their rates of return in order to remain competitive. These other forms of investment include taxable and tax exempt bonds, interest earning accounts, and real estate, including home ownership.

The macro economic effect of the proposal will likely result in more employment and a higher level of economic output, at least in the short run. Corporate stock values should increase. In the long run, interest rates may increase because of additional federal borrowing due to an increased federal deficit. An increase of approximately 75 basis points in long term interest rates is predicted by Macroeconomic Advisors (MA), LLC, one of the premier economic analysis firms in he country.

Tax Effects Of The Dividend Proposal On The LIHTC

Unfortunately, the dividends exclusion proposal reduces the value of tax credits like the Low Income Housing Tax Credit (LIHTC). The value of tax credits is reduced compared to today's value of the tax credits because corporate earnings that are exempted from tax by the credit are taxable to the shareholder and will not increase the cost basis of the shareholder's stock when the corporation retains the earnings. Today, the use of the tax credit by the corporation has no effect on the tax treatment of dividends paid to the shareholder or the cost basis of the shareholder's stock, i.e., there is no tax cost to the shareholder for the use of the credit by the corporation. The reduced value of the credit due to the change in the tax treatment of corporate earnings is expected to lower the price corporations will pay for the LIHTC.

The computation that reduces the value of the LIHTC relative to the current treatment is performed as follows. In order to determine the amount of the corporation's dividend that is either exempt from tax at the shareholder level or used to increase the cost basis of shareholders' stock, the corporation must perform a calculation to determine it's excludable dividend amount (EDA). The shareholder's excludable portion of any dividend received is the amount of the dividend payment that bears the same ratio to the dividend payment as the amount of the corporation's EDA to all dividends paid by the corporation. If EDA exceeds the dividends

paid during the year, the cost basis of the shareholders' stock is increased by the amount of EDA the corporation did not pay out as dividends.

The computation of EDA that affects the value of tax credits is:

$$EDA = \frac{\text{Federal Income Tax} - \text{tax credits except for the Foreign Tax and AMT credits}}{\text{Highest Corporate Income Tax Rate (35 Percent)}}$$

In the formula above, the amount of a corporation's EDA is reduced when tax credits like the LIHTC are subtracted from the corporation's Federal income tax. When the amount of federal income tax is reduced, a smaller EDA amount is computed after the federal income tax is divided by the 35 percent corporate tax rate. As EDA becomes smaller, the portion of the shareholder's dividend that is excluded from the shareholder's income is also smaller. The ratio or the shareholder's excluded dividend to the overall dividend paid to the shareholder is the same as the ratio of EDA to all corporate dividends. In addition, when the amount of EDA is made smaller by subtracting credits from the corporation's federal income tax, the amount by which EDA exceeds dividends paid also becomes smaller. As a result, there is less EDA excess over dividends paid to increase the cost basis of the shareholder's stock.

The impact of the Administration's dividend proposal on the price that will be paid for tax credits such as the LIHTC depends on the mix of dividends paid and taxed earnings retained in the future. The value of the LIHTC is more adversely affected if more dividends are paid relative to earnings retained (i.e., the more tax benefit forgone, the lower the value of the credit). Since the proposal is designed to eliminate a bias against paying dividends, it is likely that dividend payments will increase relative to the current level of dividend payments.

The value of a dividend exclusion to the shareholder is based on the shareholder's current income tax rate that can be as much as 38.6 percent under present law or 35 percent if the stimulus package is enacted into law. The value of the dividend benefits the shareholder in the year the dividend is paid. If the LIHTC is used to increase earnings to be distributed as dividends in the future, the credit will have to generate enough extra earnings so that the shareholder can pay the personal income tax on dividend while still getting as much of the dividend as the shareholder would have received tax free without the use of the credit.

Shareholders receive less of a benefit when the basis of the shareholder's stock is increased as a result of the corporation retaining taxed earnings. The shareholder does not realize the value of the increase in the stock's cost basis until the stock is sold. At the time of sale, the shareholder will probably be subjected to the 20 percent capital gains rate on the difference between the stock's cost basis and its sales price. The capital gains tax that is not paid on stock sales because of the increased cost basis of the stock is less than the ordinary income tax that is not paid when tax free dividends are distributed. In addition, the smaller tax benefit of the stock cost basis adjustment must be discounted to its present value because it will not occur until some point in the future.

Operation Of The LIHTC Program

The LITHC program produces 115,000 units of affordable housing each year. Credits are allocated by state agencies and claimed by investors over a 10 year period. The affordable housing property must stay in compliance with the requirements of the LIHTC program for 15 years for investors to avoid a recapture of the tax benefits of the credit they claim over the 10 year period.

Affordable housing built with the LIHTC has different layers of support and operates on narrow margins. States try to serve the lowest income tenants possible and locate affordable properties in areas where development frequently is difficult, such as rural and inner city areas. A developer who sells the LIHTC to investors uses the proceeds from the sale as equity in LIHTC properties. The amount of equity generated with the credit reduces the debt financing the property must carry. As a result, rents lower than market rates can be charged to eligible tenants, i.e. tenants at or below 60 percent of area median income, because less debt is carried on LIHTC properties than on market rate properties.

There are other factors that affect the purchase of LIHTCs and influence the analysis of the impact of the dividends proposal on the credit. Some purchasers of the LIHTC are in the business of investing in real estate and can be expected to continue to invest in the credit as part of their business. Although these businesses will remain a part of the market for purchasing credits, they will buy the credit at market prices if prices decline. If companies that are not in the real estate business reduce their purchases of LIHTCs, the price of the credit may go down despite the continued interest of businesses in real estate. Some businesses purchase credits be-

cause they are subject to legal requirements that credit purchases satisfy, such as the Community Reinvestment Act (CRA). The credit is purchased today to meet these requirements. While the credit will continue to satisfy the obligation of these firms under CRA, other forms of investments can be made to satisfy CRA requirements. As a result, the alternative investments may become more attractive when the value of purchasing the credit is reduced by the dividend proposal, reducing the CRA-driven demand.

Effect Of The Dividends Proposal On The LIHTC Program

Even a modest change in the value of the credit and the resulting reduction in the amount of equity the credit can generate will have adverse consequences on the LIHTC program. When the credit is worth less, corporations will pay less for the same amount of credits than they pay today and less capital will be available to invest in affordable housing properties.

Dividend Proposal

Two studies have been published to date that analyze an impact of the Administration's dividend proposal on the LIHTC program. The first study released was prepared by Ernst & Young (E&Y) for the National Council of State Housing Agencies (NCHSA) that predicted there would be a reduction of 40,000 LIHTC units per year, which is a 35 percent reduction from the current level of 115,000 units that will affect 80,000 people. The Mortgage Bankers Association (MBA) published the second study. The negative effects of the dividend proposal on the LIHTC program was driven by a 21 percent decrease in the prices for the credit due to the tax change in corporate earnings. The MBA study predicted the dividend proposal would actually benefit the production of LIHTC units and have virtually no negative effects at all.

There are many assumptions that must be made to perform an analysis like the E&Y and MBA studies. We believe the static assumptions in the E&Y study result in too much emphasis being placed on the effects the proposal would have on the production of units. The changes induced by the full tax proposal will provide an incentive for some firms to become Chapter C corporations that are now Chapter S, which will provide new demand for the LIHTC. Some corporations that have average tax rates below 35 percent will benefit from the EDA calculation that uses an average tax rate of 35 percent. Such corporations will effectively be able to pass more of the benefit of the credit to the shareholder without tax. The combined effect of more demand for the LIHTC from new sources is uncertain but in the direction of tempering the price impact. It is not clear to us how the MBA study was actually performed. We are continuing to review it now.

It is our best estimate at this point that the 21 percent estimate of the price reduction in the E&Y study is overstated and that the emphasis on units produced in the analytical formula fails to reflect the full range of the impact of the dividend proposal. NAHB estimates that a more realistic decline in the value of the credit is 10 to 15 percent. We also believe that there will be significant revisions in state priorities for the LIHTC program if the dividend proposal is enacted into law. Higher income tenants will be sought and fewer properties will be built, particularly in hard to develop areas.

LIHTC properties are financed in three layers—equity, soft gap funding and first mortgage debt. While the exact impact of dividend proposal on the amount of equity available for LIHTC properties is still open to question, it seems certain that a significant erosion will occur, requiring offsetting increases in the other funding slices. Most observers agree that current federal and state sources of soft financing/grants are already fully tapped. That leaves first mortgage debt financing as the only available offset and unfortunately, as discussed below, this avenue has severe limitations on expansion.

These limitations, simply stated, revolve around the difficulty in increasing rental income from LIHTC properties. Loans for LIHTC properties are underwritten on the basis of the capacity of the ongoing net operating income of the property (the margin of rental and other income over operating expenses and reserve payments) to cover mortgage payments. Lenders establish minimum debt coverage or debt service ratios (DCRs) that determine how much mortgage debt a property can support. Fannie Mae, for example, enforces a debt service ratio of 1.15 percent, requiring properties to generate operating income significantly in excess of expenses. Other financing programs require DCRs in the 1.10 to 1.20 percent range.

Such limitations on debt coverage greatly limit the capacity of LIHTC properties to take on additional debt needed to significantly offset the expected reduction in equity funding. Rents on eligible LIHTC units by law cannot increase above 30 per-

cent of 60 percent of area median income. This is the constraint producing the program's unusually low loan-to-value ratios. Therefore, the impact of the dividend proposal provision on the number of units produced and the characteristics of households and areas served will be well beyond incidental and ultimately determined by the capacity and willingness of state allocating agencies to fund properties at higher rent levels.

Adjustments are possible. State allocating agencies strive to serve households at the lowest income levels possible. The states could redirect the program to those earning closer to the maximum statutory limit of 60 percent of area median income. States also likely will attempt to allocate more credits to properties than they do today in an effort to reduce debt requirements. Reducing service and increasing rent loads for low-income families is not likely to be a welcomed option and will be limited by the facts that any increase in incomes served would come from levels that are, in most cases, not that far below the statutory maximums and market rents in many areas would not permit significant or any rent increases. This would be particularly true in rural and economically distressed urban areas.

These factors lead NAHB to conclude that the dividend proposal component of the President's proposal would have a significant adverse impact on the supply of rental housing available for low-income families. This effect would take the form of a sizable reduction in the number of units produced each year, as well as a shift in the composition of the units produced away from those serving families at lower income levels and located in rural, urban and other difficult to develop areas.

Solutions*:*

There are two approaches that can be used to avoid a negative impact of the Administration's dividend proposal on the LIHTC. The first approach would be to exempt the LIHTC from the adverse effects of the elimination of the double taxation of corporate earnings. This can be done within the structure of the Administration's proposal by treating earnings corresponding to the LIHTC as taxed earnings. Other methods not affecting the LIHTC by a dividend proposal would involve structural changes of the proposal such as exempting all or part of dividends received by shareholders as exempt from tax or by shifting the tax benefit of eliminating the double taxation. The tax benefit could be shifted to a corporation with a corporate deduction for dividends paid.

The other approach to protecting the LIHTC from the adverse consequences of the Administration's dividend proposal would be to make up for any adverse impact on the credit from the dividend proposal by expanding the availability and the market for the credit. This proposal requires adjustments to the program and other parts of the tax code that limit the market for the credit.

1. Exemtping The LIHTC From The Effects Of The Dividend Proposal.

a. Treat Earnings Excluded from Income by the LIHTC as Taxed.

This option would treat corporate earnings that are not subject to tax because of the LIHTC in the same fashion as earnings subject to foreign taxation and exempted from federal taxation by the Foreign Tax Credit (FTC) or earnings that were previously subject to the AMT and credited for past payments of that tax. The proposal exempts the LIHTC from the impact of the dividend proposal because the earnings that are exempted from tax by the LIHTC are treated as taxed earnings that can be paid out as tax free dividends or used to adjust the cost basis of a shareholder's stock. The solution fits into the format of the dividend proposal in the Economic Growth Plan without changing the basic structure of the proposal.

As discussed above, EDA is computed with the following formula:

$$\text{EDA} = \frac{\text{Federal Income Tax} - \text{tax credits except for the Foreign Tax and AMT credits}}{\text{Highest Corporate Income Tax Rate (35 Percent)}}$$

If the LIHTC were added to the FTC and AMT credit in the formula, the adverse consequences of the dividend proposal on the LIHTC would be avoided.

b. Equivalent Solutions To Treating LIHTC Excluded Earnings As Taxed.

There are other approaches that could accomplish similar results as the FTC treatment of the LIHTC. For example, providing corporations with a dividends-paid deduction for dividends paid to shareholders from taxable earnings and a capital basis adjustment for shareholders' stock when taxed earnings are retained by the corporation, or, provide shareholders with an exclusion (with or without a limit) for dividends received would effectively protect the LIHTC from the adverse consequences of a dividend exclusion. In fact, the Treasury Department made such a proposal in 1992 in "A Recommendation for Integration of The Individual and Cor-

porate Tax Systems." The Treasury Department's 1992 proposal would exempt all dividends received by a shareholder from ordinary income taxes. A capital gain tax would apply to dividends that represent a return on capital rather than ordinary income earned by the corporation.

2. Expanding LIHTC Limits And Market

Today's LIHTC market among individuals is limited by limits on passive loss deductions and the imposition of the alternative minimum tax. Eliminating these restrictions could substantially expand the LIHTC market. However, removing these restrictions would not fully compensate for reducing the corporate market for LIHTCs due to the Administration's dividend proposal. Individuals cannot be expected to pay as much for the credits as the current group of corporations that make up the market. The corporations are in a better position to assess the risk of purchasing credits and require a lower rate of return than investors who cannot perform the same level of risk assessment. As a result, if the program is to be maintained at current levels by expanding the market for the credits among individuals, the amount of credits that can be sold to raise equity, as well as the amount of credits that can be dedicated individual properties, would need to be increased to make up for inefficiencies in the individual market. A more detailed discussion of these changes follows.

a. Increase the amount of LIHTC individual investors can take annually against ordinary (non-passive) income.

The current very low deduction limitation—$25,000—on the amount of LIHTC individual investors can take each year to offset individual ordinary income tax liability should be raised or eliminated. The current limit has all but eradicated the market for the LIHTC among individuals, which reduces demand for LIHTCs and, consequently, the amount available each year for the apartment investment the LIHTC can generate from any particular amount of LIHTCs.

b. Allow the use of the LIHTC to reduce Alternative Minimum Tax (AMT) liabilities.

Individuals use the LIHTC to reduce their regular tax liability. However, the LIHTC cannot be used to offset the Alternative Minimum Tax ("AMT"), which applies to increasing numbers of individuals. To the extent that potential LIHTC investors are subject to the AMT, they either pay less for the LIHTCs they buy, reducing the dollars available from the LIHTC for housing, or may refuse to buy LIHTCs at all. Providing an exemption from the individual AMT would increase the marketability of the credits and help alleviate any reduced value due to the elimination of the double taxation of corporate earnings.

c. Remove LIHTC Limits per Project & Increase the volume cap on LIHTCs

Currently, the volume cap on LIHTCs is $1.75 per capita per state indexed for inflation and with a "small state minimum" of $2 million. LIHTCs per project are limited to four percent and nine percent of total development costs, depending on the type of transaction.

This proposal fills the financing gap due to the Administration's dividend proposal by eliminating the four and nine percent credit limits per project, allowing states to put as much credit as is needed (subject to the required feasibility analysis by the allocating agency) into an individual project. The increase in credits per project is necessary because less capital will be raised by the LIHTC from the individual market than the current corporate market. An increase in the state per capita allocation and minimum state allocation must also be made to keep the program at current operating levels to make up for the additional credits each project will require. Without more credits per state, some projects would be fully funded while others would not be funded and a net loss in affordable units would result. If more credits per state under the per capita and minimum state allocation are allowed, then the current level of production could be maintained, even with a lower credit price due to the inefficiencies of the individual market.

I urge you to consider the unintended adverse consequences of the Economic Growth Package on the LIHTC and devise solutions that will keep the program operating at the same levels as it does today. NAHB looks forward to working the Ways and Means Committee and Treasury Department to fully protect the LIHTC.

Thank you for the opportunity to present this statement for the record.

Statement of Michael E. Baroody, National Association of Manufacturers

I. Introduction

The National Association of Manufacturers (NAM) appreciates the opportunity to comment on the economic growth provisions in the Administration's FY 2004 budget proposal. The NAM is the nation's largest industrial trade association, representing 14,000 members (including 10,000 small and mid-sized companies) and 350 member associations serving manufacturers and employees in every industrial sector and all 50 states. Headquartered in Washington, D.C., the NAM has 10 additional offices across the country.

Economic growth is key to our nation's future, and manufacturing is key to economic growth. The NAM's mission is to enhance the competitiveness of manufacturers and improve American living standards by shaping a legislative and regulatory environment conducive to U.S economic growth, and to increase understanding among policy-makers, the media and the general public about the importance of manufacturing to America's economic strength.

At no time in history has NAM's mission been more important than now. Manufacturing is at a crossroads—it was the first sector to experience the recession and it remains at the center of our country's anemic economic recovery. Corporate profits are down, industrial production is lackluster and business investment is off. The recession has caused the loss of two million manufacturing jobs and many smaller manufacturing companies.

In the current economic climate, it is critical for policy-makers to focus on economic growth, which is essential to overcoming many of the problems facing manufacturing and other sectors of the economy.

The NAM strongly supports President Bush's economic growth plan because it offers a creative mix of incentives that will increase consumer spending, encourage aggressive investment in the stock market and spur new capital investment by business. American consumers have played a major role in the vibrant economic growth experienced by our country in recent years. The President's proposal to accelerate the individual tax-rate cuts scheduled for 2004 and 2006 will help shore up consumer confidence and spending. Because many small businesses pay taxes at the individual rate, they will benefit from the individual rate cuts.

Small businesses also will benefit from the proposal to triple the allowance for expensing capital investments from $25,000 to $75,000 and expand the availability of the incentive. This will make it easier for small manufacturers to increase investment and create jobs. In addition, the proposal to eliminate double taxation of dividends will boost business and consumer confidence, reduce the cost of investment capital and encourage business to invest more in new plants and equipment.

II. Individual Tax-Rate Cuts

American consumers have been key to the economic growth of recent years and individual tax relief is a critical piece of any economic growth package. Under the tax-relief tax package enacted in 2001, additional tax-rate cuts are scheduled for 2004 and 2006. The President's proposal will accelerate these tax cuts to Jan. 1, 2003, providing tax relief for everyone who pays income taxes and leaving more money in workers' paychecks to spend, save and invest. Many families will receive additional tax relief under proposals to end the "tax penalty" paid by married couples and increase the child tax credit.

At the same time, more than 23 million small businesses—including more than 5,000 NAM members—that pay taxes at the individual rates will receive a tax cut. Small businesses are responsible for more than 70 percent of the new jobs created in the United States, new jobs that account for half the output of the economy. This tax savings will provide business owners with money to expand their companies and create new jobs. In a recent survey, the NAM's small manufacturers identified a cut in individual tax rates as the tax incentive that would have the most positive impact on their companies' ability to grow.

III. Small Business Investment Incentive

Continued sluggish capital investment continues to be one of the biggest impediments to a strong U.S. economic recovery. The President's proposal to allow small businesses to write off $75,000 of equipment purchases (up from $25,000 in current law) will provide an additional growth incentive for small businesses.

Expanded investment incentives, like the expensing provision, will reduce the after-tax cost of capital investments for many small businesses and help spur capital investment and job creation. In fact, in the survey cited above, NAM's small manufacturers ranked expanded expensing just below rate cuts as a tax incentive that would have the most positive impact on their companies' ability to grow.

IV. Tax-Free Dividends

Under current law, corporate earnings paid out as dividends to shareholders are taxed twice: once at the corporate level and once at the shareholder level. This tax treatment causes a bias against corporate earnings and penalizes equity financing.

The President's proposal to eliminate the tax on dividends received by shareholders will increase the real rate of return of all dividend-paying stocks. Higher yields will boost stock values, leading to increased investor confidence in the stock market. Similarly, higher stock prices will reduce the cost of equity financing for corporations. This will encourage firms to rely more on equity financing, leading to higher investment spending and a larger capital stock.

Eliminating the double tax also will make the United States more competitive—most of our major trading partners provide some tax relief for corporate dividends. Right now, the United States has the second highest dividend tax rate in the Organization for Economic Cooperation and Development (OECD).

The dividends-exclusion proposal is particularly important to manufacturers. In 2002, just under 300 of NAM's large, publicly traded member companies paid out more than $100 billion in dividends to shareholders. Tax-free dividends will encourage more shareholders to invest in the equity market and encourage more companies to pay dividends. At the same time, investors will put less pressure on companies to increase share prices in the short term, a development that will have a positive impact on corporate governance.

V. Conclusion

In a recent survey of all NAM members, more than 90 percent of respondents indicated that, to achieve a faster recovery in 2003, it was important to enact an economic growth package including tax relief for consumers, investors and businesses. A carefully crafted tax package, like the growth package proposed by President Bush, will provide the boost needed to push the economy into high gear and ensure durable growth in the future.

The NAM also believes there are a number of other pro-growth tax provisions that would benefit the American economy. To encourage capital investment, productivity and job creation, there should be further acceleration of depreciation. The tax relief enacted in 2001, including estate-tax repeal, should be made permanent. The ongoing impasse with the European Union in the World Trade Organization over taxation of extraterritorial income (the FSC/ETI case) must also be addressed, and reforms in the international tax arena should be enacted to enable U.S. companies to effectively compete in the global marketplace. We also need a permanent R&D tax credit that benefits the largest number of companies and pension reforms to encourage greater participation in the private retirement system. Finally, to ensure that these tax law changes benefit all manufacturers, action is needed to address the problem of the corporate alternative minimum tax (AMT), the "anti-manufacturing tax."

In sum, restored economic growth is essential to achieving our critical national objectives, particularly successful prosecution of the war on terrorism, increasing productivity, saving and creating jobs and the eventual return to budget surpluses. A strong and growing economy is especially important for manufacturers, as they started to feel the recession six months before the rest of the economy. We believe strongly that tax relief is key to restoring durable economic growth and generating federal budget surpluses. The NAM welcomes the opportunity to work with the committee to advance the President's economic growth package as well as "follow-on" pro-growth tax policies.

Statement of Raul Yzaguirre, National Council of La Raza

Introduction

My name is Raul Yzaguirre, and I am President of the National Council of La Raza (NCLR). NCLR is a private, nonprofit, nonpartisan organization established in 1968 to reduce poverty and discrimination and improve life opportunities for the nation's Hispanics. NCLR is the largest national Hispanic constituency-based organization, serving all Hispanic nationality groups in all regions of the country through a network of more than 300 affiliate community-based groups.

NCLR established its Economic Mobility Initiative several years ago in an effort to address the economic issues faced by Latino working families. The foundation of this project is to explore the financial and economic security of the nation's Latino families, and to develop and propose clear public policy measures to improve the

ability of Latino families to move more successfully into the ranks of the American middle class. With this charge, NCLR has committed itself to focusing on many issues relating to asset accumulation and wealth-building, such as personal savings and investment, retirement security, pension coverage, and homeownership—policy areas shaped and influenced by federal tax policy.

Because of the increasingly influential role of Latino workers and consumers in the U.S. economy as well as the economies of cities and states, Hispanic families have a significant stake in the debate over the Administration's economic growth plan. Latinos maintain over $580 billion in consumer buying power, account for almost half of the growth in the labor market over the last five years, and make up one in five new U.S. homeowners. The right economic plan must include measures that generate real business activity, create more jobs, avoid serious budget deficits, and directly benefit hardworking American families. Most importantly, in our view any economic plan enacted must reach Latino families to the same degree as other American families, especially the millions working hard to succeed and save for the future. Therefore, I appreciate the opportunity to provide remarks on H.R. 2, the *Jobs and Growth Tax Act of 2003*.

Budget and Tax Policy

From a Latino perspective, the debate over how to restore growth in the U.S. economy has everything to do with status and outlook of the federal budget. For Hispanic families, getting our proverbial "house in order" is a major priority.

In the last two years the nation has gone from budget surpluses and widespread prosperity to huge budget deficits. A $200 billion-plus deficit is projected for this year alone, and it is expected to soar to $1.8 trillion in the next ten years.

Over half of states are now facing budget shortfalls forcing many to propose cuts in social programs. Deficits were estimated to be deepest in the three states where nearly three in five Latinos live: California, Texas, and New York.

This comes at a time when workers are most in need of assistance in providing for the housing, nutritional, and health needs of their children. The budget situation also comes at a time when we need greater, not smaller, investments in federal and state programs that guarantee equal opportunity and ensure that those who work hard and support their families through their own efforts are able to do so.

The existing demands on the budget are serious, not to mention new costs for homeland security and as of yet unknown sums to support war efforts abroad, and the Administration's estimated $726 billion economic plan is just too expensive. There are more modest and affordable ways to restore growth in the U.S. economy, and a better approach than the initial Administration package would ensure that all hardworking American families directly benefit from any economic plan.

Tax Cut on Stock Dividends

Despite their contributions to the economy, many Latino families do not own stock or participate in any employer-sponsored pension plans, including those that rely on dividend income. In fact, while people with income below $50,000 account for over 40% of those receiving dividends, they receive only 18.5% of all dividend income. With the average Latino household earning a median income of $33,565, many would likely receive little or no benefit from the $396 billion tax cut measure on corporate dividends—the centerpiece of the Administration's proposal. Moreover, experts confirm that this measure would have no simulative impact to the economy in the short term, and while some economic growth over the long term is plausible it could be offset by losses in investments in corporations that do not provide dividends.

Implementing a tax cut on stock dividends may also have the unintended consequence of hurting useful tax credit programs for Latino families, such as the low-income housing tax credit (LITC), which has financed more than 1.5 million homes for low-income families. Latinos have a strong desire to become homebuyers and own a piece of the American Dream. LITC is an important tool for families wishing to own a home and build wealth and therefore, efforts to undermine it, however unintentional, will adversely affect the financial security of many low-income families.

In our view, the upside of this measure is dubious at best, while the downside is clear; it has very little direct positive impact on most low- and moderate-income families including most Hispanic families, it will worsen the nation's budget outlook, and will threaten our nation's commitment to long-term domestic priorities. Congress should drop this measure entirely from its economic plan.

Acceleration of Tax Cuts on Idividual Income

Carefully targeted tax benefits can stimulate consumer spending and economic activity while providing important financial relief to families. For example, low-income families, including over one-third of Hispanic households, have benefited greatly

from the Earned Income Tax Credit (EITC) and the partially refundable child tax credit (CTC). The combined average EITC and CTC refund for Latino families was estimated at $2,359 in 2000 and will potentially increase to nearly $3,600 by the end of the decade. When even a modest portion of this refund is channeled into savings, it potentially results in measurable increases in wealth and financial security for Hispanic families. In 1998 the median Hispanic family maintained 4% of the wealth of the median White non-Hispanic family.

Given the potential benefits for low-income workers, NCLR supports certain provisions in H.R. 2. First, we support the expansion of the 10% income bracket, which will lower the tax liability of low-income workers and put more money in the pockets of those who need it the most to support their families. Second, NCLR has in the past formally supported the elimination of the marriage penalty tax and therefore, we currently support accelerating its repeal ahead of schedule. Finally, NCLR supports increasing the child tax credit from $600 to $1,000 per child this year. Tax credits, preferably those that are refundable, are a more effective way of reaching Hispanic working poor families who are deeply impacted by taxes and need assistance to offset the tax burden on their families.

In addition to more tax credits geared toward families, tax rebates to low-income workers with no tax liability are promising features of any economic growth plan. Last year during debate over an economic stimulus proposal, the Administration, along with members of Congress from both parties, supported a tax rebate to workers who did not receive a rebate in 2001. A stimulative effect on the economy would most likely result from rebates to low-income workers because these workers are likely to spend a high proportion of any new income they receive. For this reason, NCLR believes income tax rebates of up to $300 per person and $600 per working couple, regardless of tax liability, should be included in the economic growth package.

NCLR will remain supportive of tax measures that benefit low- and moderate-income families. However, most of the benefits conferred in the 2001 tax cut legislation missed the bulk of Latino families, especially those in the lowest tax brackets. The tax cuts were egregiously tilted to benefit the wealthiest Americans, and Hispanic families received very few direct benefits. Furthermore, because many Hispanic working poor families are disproportionately burdened by payroll and sales taxes and do not owe federal income tax, the 2001 tax cuts had no impact on those most in need of relief.

Incentives for Small Business

NCLR agrees that under certain economic circumstances, such as when consumer spending is strong, encouraging businesses to increase investment spending or hire more workers can stimulate economic growth. H.R. 2 would increase the amount small businesses would be allowed to expense for the cost of new investments—from the current $25,000 to $75,000. But given that businesses primarily base production, investment, and hiring decisions on expected consumer demand rather than tax incentives, it remains unclear how effective this provision would be in the short term. The loss of tax revenue associated with this measure, on the other hand, could have a clear and harmful impact on the budget deficit.

Conclusion

NCLR, on behalf of the nation's 40 million Hispanics, wants to support an economic growth plan that is modest in size and yet sufficient to help workers find new jobs, enhance the ability of families to meet rent and mortgage payments, help workers save, and generate enough spending to stimulate the economy. This means that the economic growth package should provide as much direct benefit and relief to Latino families as to other hardworking American families and should not put the government at great financial risk in the long run. Recent figures from the Congressional Budget Office, which estimate a $1.8 trillion deficit in ten years, should create considerable alarm as should the warnings from Federal Reserve Chairman Alan Greenspan that the proposed growth plan may, in fact, have dire consequences for the economy. In addition, economic growth plans must also consider the fiscal conditions in the states. H.R. 2 may have an indirect negative impact on state budgets. Budget deficits are already estimated to be severe in key states where Latinos reside. Because many states tax income and investments based on rules under the federal tax system, the tax cuts included in the proposal may significantly reduce state and local revenues, exacerbating the fiscal situation. Therefore, state funding for key programs may be threatened by additional tax cuts. While this falls outside the scope of H.R. 2, I wish to echo the concerns of several state governors who have called for much-needed federal assistance to meet not only critical needs in edu-

cation and health care but to pay for infrastructure and homeland security expenses.

Yet, in spite of these serious reservations about H.R. 2, it appears that some in the Administration and Congress would rather force Americans to accept their plan as is rather than work with lawmakers to develop a more affordable, less risky, more equitable growth package. The initial plan costs too much, disproportionately benefits Americans in the highest income brackets, and would lead to record-high budget deficits at a time when there are serious economic demands on the nation, not the least of which is an impending war in Iraq. By working with the President, Congress can develop and enact a more balanced and effective plan. But lawmakers will need to fight hard on behalf of all American families if they are to win the support of Latinos.

Statement of the National Education Association

Members of the Committee:

The National Education Association, representing 2.7 million educators across the country, is pleased to submit the following testimony on the need for the Federal Government to provide fiscal relief to states. We request that this statement be made a part of the printed hearing record.

A Crisis in the States

States are facing their worst fiscal crisis since World War II. The budget shortfalls are huge: As a share of states' overall budgets, they average between 13 percent and 18 percent. Though states have taken painful steps to end deficits, the collective shortfall for FY 2004 is estimated at $80 billion and growing. States also are reporting that FY 2003 budget gaps have grown nearly 50 percent just since November.

Cuts in programs to make up these deficits are taking a toll on everyone as states release prisoners, cutback on safety by reducing highway patrols, eliminate some Medicaid programs and force colleges and universities to increase tuition.

The Impact on Education

NEA members know that a strong America needs strong public schools. And, they know that funding is the key. The major difference between superb public schools and struggling public schools is clear—**money**. Adequate, equitable funding is the foundation on which excellent public schools are built.

Yet, today our public schools face a funding crisis, exacerbated by the severe state budget shortfalls. In FY 2002, 17 states reported cutting funding for K–12 education; in FY 2003, 14 states cut education funds. More cuts are expected in state legislatures for FY 2004 as legislators grapple with looming shortfalls. Cuts in K–12 education have delayed much needed renovation and construction, eliminated after-school programs and, in some places, reduced the number of school weeks. Students across the country are sitting in larger classes, paying to participate in school sports, and losing access to classes in music, art and foreign language.

In the higher education arena, nineteen states have cut spending, forcing cancellation of classes and tuition hikes of around 10 percent.

Snapshots from around the country highlight the devastating impact of these cuts:

- Oklahoma has laid off 2,800 school employees.
- Des Moines, IA plans to cut 110 teachers—4 percent of its total workforce.
- Syracuse, NY was forced to eliminate 15 teaching assistant positions—most of whom were working with special education students.
- The School Board in Santee, CA may cut 25 of its 287 teaching positions.
- Elgin, IL is eyeing a 33 percent reduction in its teaching staff.
- Charleston, SC is cutting twenty five percent of school nursing positions.

The Need for Federal Action—A One-Time Unrestricted Grant to States

Failure to provide states and communities immediate fiscal relief will jeopardize gains made by students and public schools the last several years and will delay any economic recovery.

Therefore, NEA urges Congress to include in any economic stimulus package a one-time $50 billion grant in unrestricted aid to states to help address current state fiscal crises. We also urge Congress to provide the funds as a directed appropriation, which would not count against the Budget's discretionary spending caps.

Providing an unrestricted grant will send money where it will have the biggest immediate economic impact: into communities for funding critical needs in education, health care, and infrastructure, and into the hands of the unemployed. The National Governors Association, National Conference of State Legislatures, National League of Cities, U.S. Conference of Mayors, and the National Association of Counties have also called on Congress to provide such assistance.

The Budget Resolution reported by the House Budget Committee assumes $726 billion for an economic recovery tax cut package. A $50 billion grant to states would comprise only 7 percent of this total—a small percentage that would make a big difference.

The Danger of the Dividend Exclusion

In contrast to the immediate help $50 billion in unrestricted aid would offer, proposals to exempt dividends from taxable income will cause states to lose revenue, thereby exacerbating the current crisis. Most state income tax systems are tied to the federal system. It is estimated that exempting dividends from taxable income would cost states as much as $5 billion per year for each of the next ten years. In addition, states and schools will be forced to pay higher interest rates on municipal bonds, including school construction bonds, in order to have tax-free bonds remain a competitive investment option in relation to what would be tax-free stock dividends.

The proposed dividend exemption will also jeopardize the Qualified Zone Academy Bond (QZAB) program. This program, which the president has recommended for a two-year extension, provides tax credits in lieu of interest to financial institutions that purchase zero interest school construction bonds. These tax credits will reduce the amount of excludable dividends available to a corporation. Therefore, the dividend exclusion will make the QZAB tax credit, along with other tax credits such as the low-income housing credit, much less attractive to corporations and will likely curtail the use of and the viability of this important program.

Conclusion

State budget shortfalls are jeopardizing public schools and the students they serve. Rather than focusing on proposals that would exacerbate this crisis, the Federal Government should focus on helping states and local governments protect critical education, health, and other services, by providing $50 billion in unrestricted aid.

We thank you for the opportunity to submit these comments.

Statement of the New Markets Tax Credit Coalition

Introduction

Chairman Thomas, Ranking Member Rangel and honorable members of the Ways and Means Committee, I appreciate the opportunity to submit testimony on the President's economic growth proposal on behalf of the New Markets Tax Credit Coalition.

The New Markets Tax Credit Coalition is a network of more than 80 community development organizations, intermediaries and investors committed to seeing the New Markets Tax Credit succeed in generating private investments in economic and business opportunities in our nation's most distressed communities.

Background on the New Markets Tax Credit and the Coalition

The New Markets Tax Credit (NMTC) was enacted in 2000 as part of the Community Renewal Tax Relief Act and is designed to increase the flow of private capital into low-income communities.

The NMTC provides a credit against federal income taxes paid by individuals or corporations that make qualified equity investments in designated Community Development Entities (CDEs). The NMTC offers investors a tax credit worth 39% of an investment over seven years—a 5% credit in years 1 through 3 and a 6% credit in years 4 through 7. CDEs, which include faith and community based organizations, will use capital raised with the NMTC to make community development investments in targeted low-income communities. Between now and 2007, the NMTC will spur at least $15 billion in private investments to promote development in poor communities.

Like the Low-Income Housing Tax Credit (LIHTC), which draws 98% of its investors from the corporate sector, we expect corporations will be the principal source of investments in New Markets Tax Credits. Corporations are attracted to the Cred-

it to offset their tax liability and at the same time make a significant contribution to community development. Due to passive investment regulations, which limit the amount of tax credits an individual can claim, we expect there will be minimal interest in the NMTC among individual investors.

Unlike the LIHTC that has a market of seasoned investors and an inventory of housing units that can be traced to LIHTC investments, the NMTC is a new tax credit. The first allocation of Credits will be awarded in the next two weeks and therefore no investors have yet taken advantage of the NMTC.

There is a great demand for the NMTC as exhibited by the 345 applications submitted for the first round of allocations worth $2.5 billion in investment volume. The applications that were submitted to the Treasury Department in August of 2002 requested Credits for $26 billion in targeted investments—more than 10 times what was available.

The Administration's Proposed Economic Growth Package:

The NMTC Coalition has two comments on the President's proposed economic growth package. First, the Coalition is concerned that the dividend tax exemption proposal as currently conceived would negatively impact the market for New Markets Tax Credits and we ask that the proposal be amended to accommodate this concern. Secondly, we encourage the committee to include an additional allocation of NMTCs in the final economic growth package in order to ensure that low-income communities, which are often impacted first and most severely by a downturn in the economy, receive immediate assistance.

1. Concerns with the Administration's Dividend Tax Exemption Proposal and its Impact on the NMTC

The New Markets Tax Credit Coalition and its advisors have concluded that the President's proposal to end the double taxation of corporate dividends will have an immediate, significantly detrimental and potentially crippling impact on the recently enacted New Markets Tax Credit Program.

The Administration's plan proposes to exclude certain dividends from individual taxation. Any dividend paid to a shareholder out of previously taxed corporate income would be excluded from the shareholder's taxable income. In order to determine whether a dividend was paid out of previously taxed income, corporations would be required to establish and maintain Excludable Dividend Accounts (EDAs). The amount of income in an EDA would be calculated based on actual taxes paid on corporate earnings.

As most companies do not distribute all their earnings, the Administration's proposal would allow for an increase in the basis of a shareholder's investment in a company by the amount of the EDA not distributed. It can be "deemed" distributed and thus increase the shareholder's basis in their investment. Assuming the value of the company increases by the amount of the earnings retained, a "deemed" dividend allows the shareholder to sell their investment without paying tax on the value increase attributable to retained earnings.

While under this proposal the NMTC would continue to benefit the corporate bottom line, such benefits would be offset by the reduction of tax-free dividends or a reduced stock basis, which would adversely impact the corporation's stock price. We firmly believe that pressure from shareholders alone would force corporations to defer investing in tax credits and instead distribute tax-free dividends to shareholders.

If passed in its current form, the President's dividend tax exclusion proposal would freeze the market for NMTCs and similar targeted tax credits. I have attached to my testimony a letter signed by 50 community development organizations and investors that are concerned about the President's proposal and how it will impact the NMTC market.

In order to preserve the NMTC and its stated mission of increasing private investment in poor communities, the Coalition recommends that the Administration's proposal be amended to provide that, similar to the treatment of foreign tax credits, any NMTCs taken should be included as a component of "taxes paid" for purposes of the EDA calculation. In effect, whether a corporation pays its taxes through direct cash payments or tax credits, its income has been subject to tax.

2. Meet the Tremendous Demand for NMTCs and Include an Additional $2.5 Billion in NMTC Allocations in the Economic Stimulus Package

As previously mentioned, the first round of applications for NMTCs closed in August 2002 and award announcements are expected within the month. While only $2.5 billion in Credits were available, the Treasury Department's Community Devel-

opment Financial Institutions (CDFI) Fund received applications requesting close to $26 billion.

This demand demonstrates both the need for capital in poor communities as well as the interest among private sector investors in the NMTC.

Due to the overwhelming demand for Credits, the CDFI Fund has qualified NMTC applications on hand with the potential to generate increased investment in poor communities if an additional allocation of Credits were made available. These applications include business and economic development deals and investment commitments that could have an immediate impact on low-income communities.

Therefore, we recommend the Committee include an additional $2.5 billion in NMTC in the final economic stimulus legislation. This additional volume would enable the CDFI Fund to award Credits to some of these qualified CDE applicants thereby spurring new private sector investments and generating new economic activity in targeted communities. We estimate the cost of this additional NMTC volume would be $42 million over five years and $700 million over ten.

I appreciate this opportunity to submit testimony on behalf of the NMTC Coalition and would be happy to answer any questions that you might have on the New Markets Tax Credit or the issues raised in my testimony.

Thank you.

Attachment 1

The New Markets Tax Credit Coalition's Statement On the Administration's Dividend Tax-Exemption Proposal

The New Markets Tax Credit Coalition is concerned that the Administration's proposal to end double taxation of corporate dividends will have an adverse impact on the implementation of the New Market Tax Credit.

The NMTC was enacted in the Community Renewal Tax-Relief Act of 2000 and is designed to increase the flow of private capital to low-income communities. Between now and 2007, some $15 billion in private investments in economically distressed communities will be eligible to receive Credits.

Next month, the Treasury Department is expected to allocate the initial round of Credits, totaling at least $2.5 billion. At minimum, the Administration's proposal will muddy corporate decision-making on Credits. Marketing for this new product may be slowed or stalled until the dividend exemption proposal is resolved.

We expect corporations to be the principal investors using the NMTC. The dividend tax exemption may act as a disincentive to these corporate investors who would be forced to choose between reducing corporate tax liability and maximizing shareholder benefits and reducing federal tax liability and investing revitalization projects through the New Markets Credit.

An indication of the need for the Credit is the great demand for the first round of Credits. While only $2.5 billion in Credits were available the Treasury Department's Community Development Financial Institutions (CDFI) Fund received applications requesting close to $26 billion—more than ten time the amount available. These applications represented distressed communities across the country.

We applaud the work of the Administration in launching the NMTC and we do not believe the dividend exclusion proposal was intended to put the NMTC at risk. However, we are concerned that if the proposal is implemented in its current form the outcome will be devastating to the Credit.

The NMTC Coalition will continue to examine the potential impacts of the dividend exclusion proposal and will share that information with the Congress and the Administration.

Organization	City, State
Access Capital Group, LLC	Shreveport, LA
Alaska Village Initiatives	Anchorage, AK
Bethel New Life, Inc.	Chicago, IL
Boston Community Capital	Boston, MA
Boston Community Loan Fund	Boston, MA
Business Carolina, Inc	Columbia, SC
CAP services	Stevens Point, WI
CBO Financial, Inc	Clarksville, MD
Chicanos Por La Causa	Phoenix, AZ

Organization	City, State
Coalition for a Better Acre	Lowell, MA
Coalition of Community Development Financial Institutions	Arlington, VA
Coastal Enterprises, Inc.	Wiscasset, ME
Community Development Venture Capital Alliance	New York, NY
Community Reinvestment Fund	Minneapolis, MN
Community Resource Group, Inc.	Fayetteville, AR
Connections for Community Ownership	Chicago, IL
Covenant Community Capital Corporation	Houston, TX
Enterprise Corporation of the Delta	Jackson, MS
Federal Home Loan of Atlanta	Atlanta, GA
Federation of Appalachian Housing Enterprises, Inc.	Berea, KY
Holm Law Firm, PLLC	Memphis, TN
Housing Partnership Network	Boston, MA
Impact Services Corporation/ Impact Loan Fund, Inc.	Philadelphia, PA
Impact Seven, Inc.	Almena, WI
Investment Builders	El Paso, TX
Kentucky Highlands Investment Corporation	London, KY
Legacy Bancorp	Milwaukee, WI
Lenders for Community Development	San Jose, CA
Leviticus 25:23 Alternative Fund, Inc.	Yonkers, NY
Local Initiatives Support Corporation	New York, NY
Los Angeles LDC, Inc.	Los Angeles, CA
Low Income Investment Fund	Oakland, CA
MACED	Berea, KY
Meridian Investments	Quincy, MA
N.M. Marketing & Communications	Baltimore, MD
National Bankers Association	Washington, DC
National Community Capital Association	Philadelphia, PA
National Community Investment Fund	Chicago, IL
National Economic Opportunity Fund	Montchanin, DE
NCB Development Corporation	Washington, DC
New Community Corporation	Newark, NY
Northeast Ventures Corporation	Duluth, MN
Northern Community Investment Corporation	St. Johnsbury, VT
Northern Economic Initiatives Corporation	Marquette, MI
Reznick Fedder & Silverman	Baltimore, MD
Rural Community Assistant Corporation	West Sacramento, CA
Rural Opportunities, Inc.	Rochester, NY
Self-Help	Durham, NC
Shorebank Advisory Services	Chicago/DC
Sustainable Growth Fund	Columbus, OH
TELACU	Los Angeles, CA
The Enterprise Foundation	Washington, DC
The National Development Council	New York, NY
The National Trust for Historic Preservation	Philadelphia, PA

Attachment 2

NEW MARKETS TAX CREDIT COALITION

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Statement of the Profit Sharing/401(k) Council of America, Chicago, Illinois

The Profit Sharing/401(k) Council of America (PSCA) applauds the Administration's efforts to stimulate the economy and encourage long-term growth. Individual savers, including the 75 million participants in employer provided defined contribution retirement plan systems, are keenly interested in restoring vigor and growth to our economy. Unfortunately, we believe that the proposals to eliminate the double taxation of dividends and for retained earning basis adjustment will negatively impact the employment based retirement system and result in an overall reduction in retirement savings, particularly among low and moderately paid workers. Any legislation must contain provisions that preserve the appeal of employer provided retirement plans.

The Administration's proposal will result in markedly lower taxes, perhaps to zero in some arrangements, on many equity investments that are not held in a tax-qualified employer based plan such as 401(k) or profit sharing plans—while not changing the tax treatment of qualified plans. This will significantly erode the tax incentives that encourage employers to accept the fiduciary obligations and expenses that are associated with offering a retirement plan. Presently, the tax code links the availability of preferential treatment on savings for business owners and highly paid workers with the retirement savings of lower paid employees. This linkage requires that employers incentivize lower paid workers to save for retirement by using expensive nonelective or matching contributions as well as conducting aggressive educational and marketing campaigns.

Under the Administration's proposal, many employers, particularly small business owners, will decide not to provide a retirement plan for their employees. This will result in lower retirement savings as some moderate and lower income employees will make smaller, or no, retirement investment contributions despite the attractiveness afforded equity investing under the proposal. Additionally, some participants in employer plans will redirect some of their retirement savings to nonqualified investments that contain no contribution limits and no holding requirements other than the capital gains holding period. This will result in lower average account balances and higher plan costs. To the extent that some employers continue to offer 401(k) plans, it may be more difficult for these plans to pass the nondiscrimination tests.

Any legislation should include provisions that maintain the incentives that encourage the growth of employer-provided retirement plans that are responsible for our nation's broad investor class.

The Profit Sharing/401(k) Council of America (PSCA) is a national non-profit association of diverse employers that provide profit sharing and 401(k) plans for their employees. For over 50 years, PSCA has promoted the use of profit sharing, 401(k) and related savings and incentive programs; identified and shared best practices with its members; and analyzed and reported plan related trends to business, government, and the media. PSCA was instrumental in the passage of Section 401(k) in 1978 and of HR 1836 in 2001.

Statement of the Real Estate Roundtable

Introduction

Mr. Chairman, the Real Estate Roundtable appreciates the opportunity to submit the following comments regarding the President's Job Creation and Economic Growth Package.

The Real Estate Roundtable is the vehicle through which the leaders of the real estate industry come together to identify, analyze and advocate policy positions on capital, finance, environmental, investment and tax issues. Roundtable members are the Chairmen, Presidents or Chief Executive Officers of the nation's 100 leading commercial, retail and multifamily real estate companies and the managing directors of major financial institutions.

The Roundtable also includes the elected leaders of Washington's major real estate trade organizations. Collectively, Roundtable members hold portfolios containing over 3.5 billion square feet of developed property valued at more than $350 billion. The industry represents over one million people involved in virtually every aspect of the real estate business.

Executive Summary

- Real estate is at least a duel sectored industry. Single family housing continues to be relatively healthy, as are the refinancing businesses and most real estate activities relating to the defense industry. Office, industrial, hospitality and retail are experiencing increasing weakness due primarily to continued weakness in demand for space and job growth in corporate business sectors.
- Catastrophic events—the technology bubble, September 11th attacks, accounting scandals, potential war with Iraq—have battered the economy to a point where normal market influences do not appear able to allow the economy to quickly assume an acceptable level of sustained growth.
- Recent monetary policies resulting in historic record low interest rates have helped to offset significant increases in operating expenses and reductions in rental income.
- Fiscal policy action is needed. We believe that any fiscal policy Congress decides to implement must be significant enough in scope and long enough in duration to cause a lasting effect on the economy. In the view of the Roundtable, a demand-led recovery that results in capital investment and long-term job creation is what Congress should be trying to achieve.
- Effective fiscal policy should help spur immediate consumption by quickly getting more after-tax cash in the hands of individuals. Also, businesses should be motivated by tax policies that reward near term capital expenditures as opposed to postponing those decisions to a later date.
- Real estate is extremely interest rate sensitive. Tax relief and spending decisions that lead to substantially higher long-term budget deficits run the risk of pushing interest rates higher. This could do more harm than good.
- Most investment real estate is held in single-level tax entities such as partnerships, limited liability companies and real estate investment trusts. Therefore, double taxation of dividends is not a direct issue. However, to the extent the dividend proposal benefits the capitalization and market value of companies operating as C corporations, real estate should indirectly benefit since these companies occupy as tenants a significant amount of leased space.
- The President's dividend proposal only applies to earnings on which a corporation has paid tax. The use of tax credits to reduce corporate level tax would reduce the amount of earnings eligible for dividend exclusion at the shareholder level. Corporate investment in low income housing tax credits and historic rehabilitation tax credits reduce corporate tax liability. The dividend proposal would

diminish the value of such credits to corporations. This likely would diminish the amount of future affordable housing stock coming to market and historic rehabilitation development. This potential diminution in this type of activity should be addressed by policymakers.

Real Estate Investment Market in the Current Economy

General Outlook

Capital investment in U.S. real estate exceeds $4.6 trillion. It generates one-third, or $2.9 trillion, of U.S. Gross Domestic Product, provides jobs for 9 million Americans and accounts for 70 percent of local government revenues.

Residential and non-residential real estate have been pillars of the economy during this recent economic downturn. The single family residential sector has been particularly resilient.

However, those pillars, particularly the commercial sector, are showing signs of weakness. We are the providers of work, shopping and living space to the other sectors of the economy. As such, the health of our industry is a reflection of the health of the users of our space. Because of long-term space leases, the timing of our economic health and that of our tenants' may not always be in sync. This has been the case in recent years when performance of many economic sectors dropped sharply and suddenly yet a downturn in real estate markets lagged. That lag time is now virtually eclipsed and real estate markets are now beginning to reflect overall economic weakness.

Restrained consumer spending and flat demand for space from business tenants is eroding real estate fundamentals in many markets and sectors across the country. The result is softening prices, reduced sales volumes, rising vacancies, declining rents and mounting property expenses.

Low interest rates have helped cushion the full effect of this erosion by reducing ownership and operating costs. However, interest rates are at near historic lows and have little room to move further downward. Until demand turns around, revenue growth will continue to decline, as ownership and operating costs increase. This is a situation which causes many in our industry deep concern.

The single family housing market also is showing some early signs of softening. Recent new home sales dropped 15 percent in one month. Housing starts, however, did not drop. This means that the rate new homes are being built is outpacing the rate they are being sold. Existing home re-sales are continuing their record rate but, as an indicator they lag new home sales.

Catastrophic Economic Events Overwhelm Marketplace

In more typical environments, we believe the marketplace should be allowed to work without the Federal Government intervening with significant fiscal policies. For real estate, as with most industries, this means there will be a normal cycle of peaks and troughs. Additionally, real estate is not one homogeneous industry but in fact is comprised of several different sectors—office, multi-family, industrial, hospitality—in many distinct markets across the country. Therefore, different sectors in different regions of the country will go through normal phases of strength and weakness at different times.

The existing economic environment, however, is not typical because of a confluence of unusual and dramatic occurrences extraordinary to normal market conditions. The economy is enduring the strain of a "triple whammy" comprised of:

- The bursting of the technology sector bubble,
- The widespread economic disruption caused by the September 11th tragedy, and;
- The corporate accounting and governance scandals led by Enron but widely encompassing dozens of other major corporations and investment firms. These scandals have brought about not only the sudden and precipitous devaluation of those companies, but also a lingering dampening effect on investor confidence.

Viewed individually, each of these events is responsible for serious, yet somewhat targeted, negative economic consequences. Taken collectively, their impact has caused damage across the economy.

Adding further strain is the uncertainty and disruption posed by the ongoing threat of terrorism and the build up to an expected military conflict with Iraq. The latter has resulted in a surge in oil prices that is equivalent to an immediate tax on every business and person in the economy. Obviously, the Iraq situation also has created a sense of paralysis among businesses and consumers who are choosing to

wait and see more clearly the outcome of the expected conflict and its consequences before proceeding with any spending, investing or hiring.

Many in our industry are concerned, however, that simply moving beyond the Iraq situation will not by itself unleash new economic growth. There are still issues of worldwide over capacity in many businesses, lack of pricing power and a potential retrenchment of consumer spending in the face of falling consumer confidence.

We question whether the marketplace can adjust quickly and effectively enough to these extraordinary influences to allow the economy to return to an acceptable growth rate. In time, of course, the marketplace will adjust to these events. How much time that will take is yet to be determined. In the meantime, the economy is likely to sputter and grow at an unacceptable rate enhancing the already considerable pain and suffering for just about everyone.

Fiscal Policy Needed to Stimulate Economy During Adjustment Period

Monetary policy and fiscal policy are the two major tools that the Federal Government has to effect economic performance. The Federal Reserve has repeatedly exercised monetary policy though reductions in the short term borrowing rate for banks. Interest rates are at historic lows and there is little room for the Federal Reserve to cut further.

In 2001, Congress enacted the $1.35 trillion dollar Economic Growth and Tax Relief Act. While a large measure, it is phased in over 10 years with much of the tax relief back end loaded. Being in only the third year of its implementation, we have yet to see the full effect of the measure reflected in the economy.

The $33 billion Job Creation and Worker Assistance Act of 2002 is fully implemented but it is somewhat targeted and temporary and has not had a broadly discernable impact on the economy.

Therefore, we believe that any fiscal policy Congress decides to implement must be significant enough in scope and long enough in duration to cause a lasting effect on the economy. In the view of the Roundtable, a demand-led recovery that results in capital investment and long-term job creation is what Congress should be trying to achieve.

Effective fiscal policy should help spur immediate consumption by quickly getting more after tax cash in the hands of individuals. Also, businesses should be motivated by tax policies that reward near term capital expenditures as opposed to postponing those decisions to a later date.

Currently, capital expenditure spending is very soft as business managers wait for signs that the economy is stabilizing. In the long-run, growing demand will result in resumed flow of capital spending, but right now policies that break this current holding pattern are needed.

Effect of Budget Deficit on Interest Rates Important Consideration

As lawmakers develop fiscal policy, they also should be mindful of the importance of low interest rates on every business and consumer in the country. Real estate is particularly interest rate sensitive since it is a relatively highly leveraged asset. Tax relief and spending decisions that lead to substantially higher budget deficits run the risk of pushing interest rates higher. This could do more harm than good.

Although some economists argue there has been no recent direct correlation between deficits and interest rates, we urge policymakers to fully explore the history concerning at what point increased borrowing demand generated by federal deficits will crowd the market causing the cost of borrowing to go up.

President Bush's Job Creation and Economic Growth Proposal

We applaud President Bush for putting forth an economic growth proposal. Our economy needs bold fiscal policy if it is to get back on track. The President's action has spurred significant congressional activity, debate, and alternative proposals. This level of engagement and attention by congressional policymakers is essential to being able to reach consensus on an economic growth package in a timely and meaningful manner.

We commend Chairman Thomas for introducing the Bush plan as legislation and proceeding without delay to hearings. Delaying the development of a recovery plan delays its implementation which, in turn, delays the recovery. The effect of delay is compounded by the fact that there is a built in lag time of about 12–18 months between passage of legislation and its impact. Therefore, we encourage all Members to Congress to work quickly and cooperatively.

be devoted to consumption and investment. Increased demand generated by an increase in disposable income is essential to reinvigorating the moribund economy. In addition, real estate and other small businesses, our commonly held in pass-through entities, such as partnerships and limited liability companies taxed as partnerships. Therefore, individual rate reduction as proposed would have the double benefit of directly helping these small businesses as well.

Dividend Tax Exclusion

Real estate companies and investors do not directly benefit from the President's dividend exclusion proposal because investment real estate is not widely held in C corporation form. Real estate is commonly held in single level taxed, pass-through entities, such as real estate investment trusts (REITs), partnerships and limited liability companies taxed as partnerships. Therefore the dividend exclusion proposal does not change the tax structure of owning real estate. However, to the extent the dividend proposal benefits the capitalization and market value of companies operating as C corporations, real estate will benefit since these companies occupy as tenants a significant amount of leased space.

Value of Low Income Housing Tax Credit, Historic Rehabilitation Tax Credit Expected to Suffer

The Internal Revenue Code contains numerous provisions which allow corporate taxpayers to reduce their taxes dollar for dollar with tax credits if they enter into certain prescribed activities. The Low Income Housing Tax Credit and the Historic Rehabilitation Tax Credit are among the better known activities. Neither of these tax benefits has arisen from what have been deemed "abusive corporate tax shelters" but are instead desirable activities encouraged by the government through the Tax Code. These credits leverage significant private-sector investment that stabilizes neighborhoods, creates businesses and jobs and boosts tax revenues.

The President's dividend proposal could significantly compromise the value of these credits. No other alternative incentive programs exist. Also, corporations that invested in these credits and expect to receive their benefit for years in the future will find their investment decision undercut.

The National Council of State Housing Agencies estimates that 35 percent fewer housing credit apartments would be produced annually if the dividend exclusion proposal were enacted as proposed. Other studies indicate a more modest impact. Nevertheless, the available stock of existing affordable housing is inadequate. Our goal should be to increase the availability of affordable housing, not enact measures that could diminish it.

The dividend proposal addresses a similar problem associated with foreign tax credits used by multi-national companies. The proposal treats the foreign tax credits as taxes paid thereby allowing earnings to be excluded from tax at the shareholder level. A similar approach should be taken concerning other corporate tax credits, such as the low income housing and rehabilitation tax credits. Such an approach would preserve the incentive for corporate investment in these areas.

Conclusion

The real estate industry has been among the best performing sectors of the economy during this three year economic downturn. However, it is now suffering from the widespread underperformance of the economy. Normally, we believe the marketplace should be allowed to work without the interference of government fiscal policy. But, our current economic circumstances are extraordinary due to the recent series of major blows to the economy—the bursting of the tech bubble, the September 11th attacks, corporate accounting and governance scandals, and the uncertainty posed by the threat of terrorism and a possible war with Iraq.

Therefore, we believe bold fiscal policy is needed to assist the economy through this difficult period. We applaud the President for putting forth a substantial growth package. Congress should move quickly and cooperatively on a package that induces long-term growth and permanent job creation.

At the same time, Congress should be mindful of how such a package affects budget deficits and by extension interest rates.

We are pleased to work with the Committee as it moves forward with its consideration of the President's economic proposal.

Rebuild America's Schools
Washington, DC 20005
February 27, 2003

The Honorable William M. Thomas
Chairman
House Ways and Means Committee
United States House of Representatives
Washington, DC 20515

Dear Chairman Thomas:

Rebuild America's Schools writes to express its strong concern that the Administration's proposal to eliminate double taxation of corporate dividends would have a severe negative impact on the Qualified Zone Academy Bond (QZABs) program. Rebuild America's Schools is a national coalition of education organizations, representing school boards, school administrators, PTAs, teachers, architects, and others—all helping local communities find the resources needed to provide children with modern classrooms.

The QZAB program offers a new and innovative financial instrument to help schools in the poorest districts raise funds to renovate buildings, invest in equipment and technology while developing curricula to maximize these upgrades. Under the program, investors receive a federal tax credit equal to the amount of interest payable on the bonds thereby relieving local taxpayers and the municipality of the burden of paying interest. Since 1998, $2.4 billion in federally subsidized bonds have been allocated among the states, the District of Columbia (D.C.) and Puerto Rico. Localities in 44 states have already used the program's funds in 2002, and 39 states have distributed all of their annual allocations since the program was implemented in 1998. Given the early success of this program, the President's FY2004 budget proposes to extend the QZAB program with an additional $400 million per year in 2004 and 2005.

Corporate investment currently makes up a significant percentage of the equity capital generated by the QZAB tax credit that enables affordable school modernization in many communities across America. Under the President's proposal, tax credits reduce the ability of corporations to increase dividends. If Congress enacts the dividend proposal in its current form, RAS is deeply concerned that many corporations may forgo QZAB credits in favor of maximizing the distribution of tax-free dividends to their shareholders. This would severely undermine the only federal tax credit available to assist school districts in upgrading their schools and curricula just at the moment this relatively new program is fully taking hold across the nation.

In addition, the dividend exclusion will place an additional financial burden on states and localities by increasing their tax-exempt borrowing rates for school construction bonds. Investors will demand higher interest rates on these bonds in light of the potential new benefit of owning corporate stock that would provide tax-free dividends under the Administration's plan. This would be particularly painful at a time when states are already facing the most dire fiscal situation since World War II. According to the National Governor's Association, budget shortfalls are mounting—$50 billion this year and $60–70 billion next year.

The recent passage of the No Child Left Behind Act (PL 107–110) and its strong emphasis on raising standards in America's classrooms reminds us that we can no longer overlook the fact that school facilities are an integral part of raising student performance. Given the overwhelming need for infrastructure assistance in communities across the nation, RAS believes that the Federal Government must do everything in its power to help school districts build and renovate their schools.

This will increase the opportunity for all students to meet the achievement objectives of No Child Left Behind.

The effect of the QZAB program—an initiative that the Administration has twice sought to extend—appears to be an unintended consequence of the new dividend proposal. RAS also believes the QZAB program supports the President's overall goal to improve our nation's educational system. We look forward to working with the Administration and your committee to ensure that the benefits of this program are preserved and extended as requested in the President's FY 2004 budget, as well as improved and expanded.

Thank you for your thoughtful consideration of these issues and for your commitment to increasing assistance for our nation's public schools.

Sincerely,

Robert Canavan
Chair

Statement of Charles G. Hardin, RetireSafe.org, Arlington, Virginia

Mr. Chairman, my name is Charles Hardin, and I am here today representing RetireSafe.org, the nation's only retirement security group focused primarily on a pro-growth, free-market message for reform. We're a network of citizen activists, organized primarily through our website, who promote a supply-side vision of prosperity for all Americans and favor ending the bias against savers and investors in the tax code. RetireSafe.org is a project of the Council for Government Reform, an organization of over 1 million senior citizen supporters across America.

I testify today in support of President Bush's jobs and growth tax package, focusing especially on the elements affecting savings in general and retirement security in particular.

Ending the Double Taxation of Dividends

Tax policy should be designed in a way to encourage people to save as much as they can, in a way that promotes ownership of assets and long-term economic growth. Fairness dictates that each dollar earned should be taxed once, and only once.

Today, dividends are taxed twice—first, as a profit of the corporation issuing them, and second as income earned by the individual who receives them. The effect is staggering. Of every dollar a corporation issues as a dividend, only about 40 cents actually ends up in the shareholder's pocket after the corporate and personal income tax structures are imposed.

About 35 million Americans receive dividend income. More than half of the recipients are senior citizens who rely on that income to supplement their meager Social Security benefits. Ending this double taxation will increase their income by almost $1000 a year.

Ending the individual tax on dividends would pump about $20 billion into the U.S. economy in 2003, boosting both investor and consumer confidence. As more money flows through the economy, the value of the stock market could increase as much as 10% (according to former Council of Economic Advisors Chairman Glenn Hubbard), growing the dollars saved by hard-working Americans in 401(k)s and IRAs.

The unfair double taxation of dividends is not only wrong—it stifles economic growth and the ability to save for retirement. President Bush has made ending the double taxation of dividends the centerpiece of his economic policy. Congress should follow his lead and act quickly to end this tax on America's retirement security.

Creating New Oppportunities to Save

All Americans should be given every opportunity to save for their retirement. Yet current rules needlessly restrict contributions to retirement accounts like Individual Retirement Accounts (IRAs) and 401(k)s.

IRAs and 401(k)s shield retirement savings from the multiple layers of double taxation present in ordinary investing. In 2001, Congress approved President Bush's plan to increase the amount people could contribute to these plans. However, there are still far too many restrictions that need to be lifted.

In addition, the hodgepodge of employer-provided retirement plans urgently needs simplification, both to encourage their availability from small businesses and the active use of them by ordinary workers.

That's why the President's plan to streamline all IRAs into new Retirement Savings Accounts (RSAs), and all employer-sponsored plans into new Employer Retirement Savings Accounts (ERSAs) is such good tax, economic, and retirement policy. We also are encouraged that the President would like to, at a minimum, accelerate the scheduled rise in contribution limits and remove some of the barriers to common-sense distributions in retirement.

We are also very supportive of the new tax-advantaged account, the Lifetime Savings Account (LSA), which would remove the bias against savings and investment for any purpose, including retirement.

We strongly urge the committee to adopt the President's plan to streamline and increase savings options for all Americans.

Killing the Death Tax

The Death Tax is one of the biggest impediments to retirement planning. Its uncertainty leaves seniors wondering whether they will leave their children and grandchildren a nest egg or a tax bill.

In 2001, as part of President Bush's first major tax cut, Congress passed a phase-out and eventual elimination of the Death Tax. The amount of an estate exempt from the tax will gradually increase from $1 million today to $3.5 million in 2009. In 2010, all estates, no matter what their value, will be exempt from the Death Tax. Unfortunately, due to Senate budget rules, the Death Tax will be reinstated in 2011. Grieving family members will once again get a visit from the tax man.

Under this bizarre scenario, our tax code actually puts a far greater incentive on dying in one year rather than the next. The Death Tax is bad public policy. It shouldn't die a slow death only to be reincarnated as the Baby-Boomers enter retirement. We should get rid of it permanently. Better yet, we should speed up the phase-out. It only serves to saddle economic growth at a time when retirement security demands more growth.

Permanently ending the Death Tax would:

- **Allow communities to build wealth inter-generationally** Not letting wealth build through generations stifles economic growth and prevents minorities and the poor from achieving the American dream.
- **Prevent the devastation of family farms and small businesses** The Death Tax devastates the children and families of property-rich but cash-poor small businesses and family farms, often leading to a sell-off of assets or the entire business to pay the tax man.
- **Allow economic decisions in retirement to be based on good investment choices rather than flawed tax policy**
- **Eliminate another form of double taxation in our tax code** The Death Tax is a particularly harsh form of double taxation, since the savings are taxed once when they are put away, and again at the owner's death.

We support the President's call to make the tax cuts of 2001 permanent, and encourage the Congress to do so.

A Good First Step Toward True Retirement Security

The President's Jobs and Growth tax package represents a quantum leap toward a system unbiased against savings and investment. Even if it all gets adopted, though, policymakers should keep their eye on the ball for true savings and retirement reform. In particular, the next few years need to yield:

- Voluntary Personal Retirement Accounts (PRAs) for Social Security, allowing younger workers to have choice and control over their retirement futures while preserving and protecting benefits for older Americans
- Free-market reforms of the Medicare system that give seniors the same choices and control over their health care decisions that members of Congress and all federal employees have (including a baseline guarantee of a prescription drug benefit)
- Elimination of the double taxation of retained earnings (capital gains), much in the same way that the President's plan eliminates the double taxation of distributed earnings (dividends)
- Elimination of the dual disincentives against productivity for older Americans—the early retiree earnings limit and the double taxation of Social Security benefits.

These and other common-sense reforms will yield an America of prosperous families and burgeoning economic growth that will make the short-term "costs" of all these ideas pale in comparison. I urge the committee to expeditiously proceed with these needed enhancements to America's economic and retirement security.

Small Business Survival Committee
Washington, DC 20036
March 6, 2003

The Honorable William Thomas
US House of Representatives
House Ways & Means Committee
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Thomas:

We are submitting the following as testimony into the official record of the House Ways & Means Committee Hearing on the President's Economic Growth Proposals:

Some in the environmental community have begun to criticize certain provisions in the tax code that allow small businesses to expense vehicle purchases that meet certain weight requirements. From the perspective of the Small Business Survival Committee (SBSC) this merely represents another tired attempt by various groups to demonize sport utility vehicles, or SUVs, along with the people who drive them. The charges of these groups are without any factual basis.

They also miss the larger issue in regards to the burdensome nature of taxes and regulation on America's entrepreneurial sector, and how government should encourage the growth of small firms. After all, they are currently shouldering the path back to robust levels of economic growth.

The Sierra Club stated in a February 11th news release that, "A long-standing provision of the tax code lets small business owners write off a portion of certain business expenses. Vehicles weighing over 6000 pounds are eligible, so that small business owners who need trucks and delivery vans can take advantage of the provision." This doesn't sound out of order, but the Sierra Club goes on to state, "But many SUVs weigh over 6000 pounds, and since that loophole . . . came to light last year, a growing number of individuals are using it to buy SUVs for what may be personal—not business—use."

This is an absurd claim. Where are their numbers to back up this charge?

Under current law, small businesses can write off, or expense within the first year, capital investments or purchases up to $25,000. Really, how many small businesses can survive by throwing such sums of money into unnecessary vehicles for a tax write-off? Certainly not the vast majority of small businesses who perpetually struggle with escalating health insurance costs, access to adequate capital and a burdensome tax and regulatory system.

The environmental movement, led by the Sierra Club, is "concerned" with the Bush Administration's proposal to increase the expensing amount to $75,000. However, this provision would be of great help to small businesses who struggle with capital expenditures, often limiting their ability to modernize, expand and create more jobs. But it remains unclear, other than vague charges of abuse, of why the environmental movement would be against it.

Changing the expensing provision to allow small businesses to decide which capital expenditures to write-off gives them the flexibility to purchase smaller SUVs, light trucks and vans if they better suit their business needs, while treating them the same as the current "6,000 lb." threshold. Some have argued in favor of increasing this "6,000 lb." threshold to deter small businesses from "exploiting the tax loophole." This is a wasteful and ludicrous proposal.

First, small businesses are not in a position, given their size, economic and cash constraints, and regulatory burden, to abuse this provision. Second, why would the environmentalists want to encourage small businesses to purchase larger vehicles that consume more gasoline?

Let's give small businesses a break.

Small businesses are already hit hardest by government regulation. An October 2001 report from the Small Business Administration's Office of Advocacy estimated the costs of federal regulations on small, medium-sized and large businesses showed the burden of federal regulations hits small enterprises hardest: the per-employee cost of federal regulations for businesses with less than 20 employees reached $6,975 in 2000. That rate is 61% higher than the cost per employee for businesses with 20–499 employees, and 56% higher than large businesses with 500 or more employees.

Not only do small businesses carry a disproportionate load of regulatory costs, but it costs them more per employee to comply with current tax law than larger firms. The per employee costs for firms with fewer than 20 employees topped the costs for firms with 20–499 employees by 92% and for businesses with 500 or more employees by 114%.

These regulatory and compliance costs take a toll on small businesses, their owners and employees, and the economy in general.

The good news is that the Bush plan will work to bring some relief to small businesses. It calls for expanded expensing of capital investment for small businesses. Currently, a business with less than $200,000 in annual investment can elect to expense $25,000 of the cost in lieu of depreciation. The President's budget proposal would increase expensing to $75,000 for firms with less than $325,000 in annual investment, as well as index those levels for inflation going forward.

This would be a very positive step forward for small businesses. Not only do we believe reforming the Section 179 expensing provision to encourage capital investment by small businesses would help them grow, but changing these rules has the added benefit of allowing small business owners more flexibility to purchase the vehicles that best suit their needs.

Let's move forward with the President's proposal to increase Section 179 expensing to $75,000 for small firms. It will help give small businesses the relief they need to help drive economic growth for our country.

Sincerely,

Karen Kerrigan
Chairman

Statement of Douglass M. Tatum, Tatum CFO Partners, LLP, Atlanta, Georgia, and Richard P. Trotter, Governmental Affairs and Services

Bridge Act Provides Needed Capital to Help Thousands of Entrepreneurial Businesses Grow and Create Over 600,000 New Jobs in First 3 Years

Introduction

Mr. Chairman, my name is Douglass M. Tatum, Chief Executive Officer of Tatum CFO Partners, LLP, which is headquartered in Atlanta: 4501 Circle 75 Parkway, Suite A–1164, Atlanta, GA 30339. (800) 828–8623, or (770) 226–0767; FAX, (770) 226–9397. Richard P. Trotter is National Partner, Governmental Affairs and Services, (619) 921–0119. Tatum CFO is a national financial services partnership, with offices currently in 26 cities. Tatum CFO provides Chief Financial Officers (and Chief Information Officers) to firms throughout the United States. The tax deferral proposal discussed herein would not benefit Tatum CFO. Thank you for your consideration of this proposal.

Mr. Chairman, we are focusing on the "BRIDGE ACT" ("Business Retained Income During Growth and Expansion Act"), a bipartisan bill introduced in the 107th Congress to allow growing small businesses ("emerging growth companies") that produce most of the net new jobs in the economy to retain a portion of their own earnings for a period as a source of needed capital financing to help them keep growing at a time when outside financing is very limited. The House bill (H.R. 3062, 107th Congress) was introduced in October 2001, by Representatives DeMint, Baird, Crane, Matsui, Manzullo, Velazquez, Toomey, Pascrell, Ron Lewis, and Hart. The Senate bill (S. 1903, 107th Congress) was introduced in January 2002, by Senators Kerry, Snowe, Lieberman, Bennett, and Bingaman.

We urge the Congress to include the provisions of this bill as part of any small business tax incentive and economic growth package. The Bridge Act is the result of extensive discussions with Members, Congressional staff, Administration officials, business executives and business trade groups, and two hearings before the House Small Business Committee (May 17 and June 26, 2001). Also, the proposal was discussed at a roundtable on entrepreneurship by the Senate Small Business and Entrepreneurship Committee (May 22, 2002), as well as at a roundtable on access to capital by the House Small Business Committee (March 1, 2002).

Summary

In summary, the Bridge Act will allow growing, entrepreneurial businesses to defer a portion of their Federal income tax liability for a limited period, payable with interest, during a critical time when outside financing is extremely difficult and costly to obtain. The bill will provide additional needed capital to be reinvested in the firm's continued growth; this added capital source will help to create a potential of more than 600,000 new jobs during the first three years, thus, helping to reinvigorate the economy. The Joint Tax Committee staff estimated that the bill, as introduced

(applicable for 2002–2005), would result in temporary revenue "losses" during the first four years, followed by revenue pick-up during the next six years—for a net revenue gain of +$1.1 billion for the 10-year period. Thus, the bill would provide important economic and job growth in the near term—when it is most needed—without a long-term revenue loss. We believe that the additional jobs and capital investment would result in more tax revenues in the long run.

Background

Tatum CFO initiated the legislative proposal in 2001, based on our firm's nationwide experience in providing chief financial officers for emerging growth businesses. We found that many small, growing and even profitable firms were encountering financial difficulty and cash flow problems as they transitioned between a small business to an "emerging growth business." Tatum CFO published a booklet discussing these and related issues, entitled *No Man's Land—Where Growing Companies Fail®*. We had numerous discussions with business executives and business trade groups, Members, and Congressional staff. We also met with Administration officials (staff of the Treasury Department, Department of Labor, National Economic Council, and Small Business Administration), and staff of the Federal Reserve.

Several business trade groups have expressed support for the Bridge Act, including the National Association of Small Business Investment Companies, Small Business Survival Committee, and Small Business Legislative Council. These groups represent many thousands of small and emerging growth businesses. The proposal has also been endorsed by Patrick Von Bargen, previously the Executive Director of the National Commission on Entrepreneurship (see his June 4, 2002 testimony before the Senate Finance Committee), and by George Gendron, Editor-in-Chief of *Inc* magazine (see article in the Dec. 2001 issue). George Gendron stated that "[T]he BRIDGE ACT is an ingenious, fiscally sound mechanism for keeping billions in the hands of a group [growth companies] that makes the most efficient use of capital."

According to recent studies by the Kauffman Center for Entrepreneurial Leadership, Kansas City, MO (*Global Entrepreneurship Monitor*, 1999, 2000) and Cognetics, Inc., Cambridge, MA (*Who's Creating Jobs*? 1999), the greatest growth in employment has been among small and mid-size entrepreneurial firms (principally, under 100 employees). Cognetics data indicate that 85% of net, new job growth for 1994–1998 was in firms with under 100 employees.

Bridge Act Provisions

The Bridge Act is designed to address two significant financial problems for fast-growing, entrepreneurial businesses on accrual accounting. First, fast-growing companies quickly outstrip capital financing based on the *personal credit* of the entrepreneur and face a "capital funding gap" for business financing needs between about $250,000 and $1 million (see attached Capital Funding Gap chart). At about $10 million in sales, where capital needs may be $1 million or more, a company can more readily attract external financing at a more reasonable cost, based on the *business assets*, to support a $1 million or more credit line. Second, fast-growing companies on accrual accounting may be profitable for tax purposes but face an increasing negative cash flow as the company expends its cash on business assets and operations to keep up with growth demands. The faster the rate of sales growth, the more the company faces a negative cash flow under accrual accounting (see attached chart on Microeconomics of Growth).

Most importantly, the Bridge Act will benefit the vital entrepreneurial sector of the economy, which has provided most of the net new job growth during the past decade, and is providing most of the new job growth in the current economy (as larger firms are downsizing). The Bridge Act will allow a firm growing by 10% or more above the average gross receipts of the prior two years with $10 million or less in gross receipts to *defer* (not deduct) up to $250,000 in Federal income tax liability for two years, and to pay the deferred tax over the following 4-year period. Interest is to be paid to the government, at the Federal tax underpayment rate, during the entire deferral period. Under the bill as introduced, the tax-deferred amount would be deposited in a trust account at a bank or other approved financial intermediary, and could be used as collateral for a business loan. The Bridge Act, as introduced, would sunset after 4 years, to allow a review by the Congress and a study by the General Accounting Office (GAO), in consultation with the Treasury Department and the Internal Revenue Service.

Mr. Chairman, the Bridge Act is a bipartisan bill that will have a significant economic-job-tax revenue multiplier effect, which is needed in the current economic situation. The bill is very timely, and needs to be passed this year, in order to have the most impact on the sluggish economy and capital markets. It will benefit thou-

sands of growing, job-producing entrepreneurial businesses (and their employees). According to a study by the National Commission on Entrepreneurship, *High-Growth Companies: Mapping America's Entrepreneurial Landscape* (July 2001), high-growth companies are located in all regions of the United States, including urban, suburban, and rural counties.

Following is a summary of the Bridge Act and the economic reasons for the bill. Also attached are charts illustrating the "Capital Funding Gap" and the "Microeconomics of Growth." Finally, there are attached summary interviews with four entrepreneurial CEOs on how the Bridge Act could benefit such growing companies: Harden Wiedemann, Dallas, Texas; Les Walker, Irvine, California; Eliot Weinman, Shrewsbury (Worcester area), Massachusetts; and Ed Rankin, Dallas, Texas.

Summary and Reasons for the Bridge Act

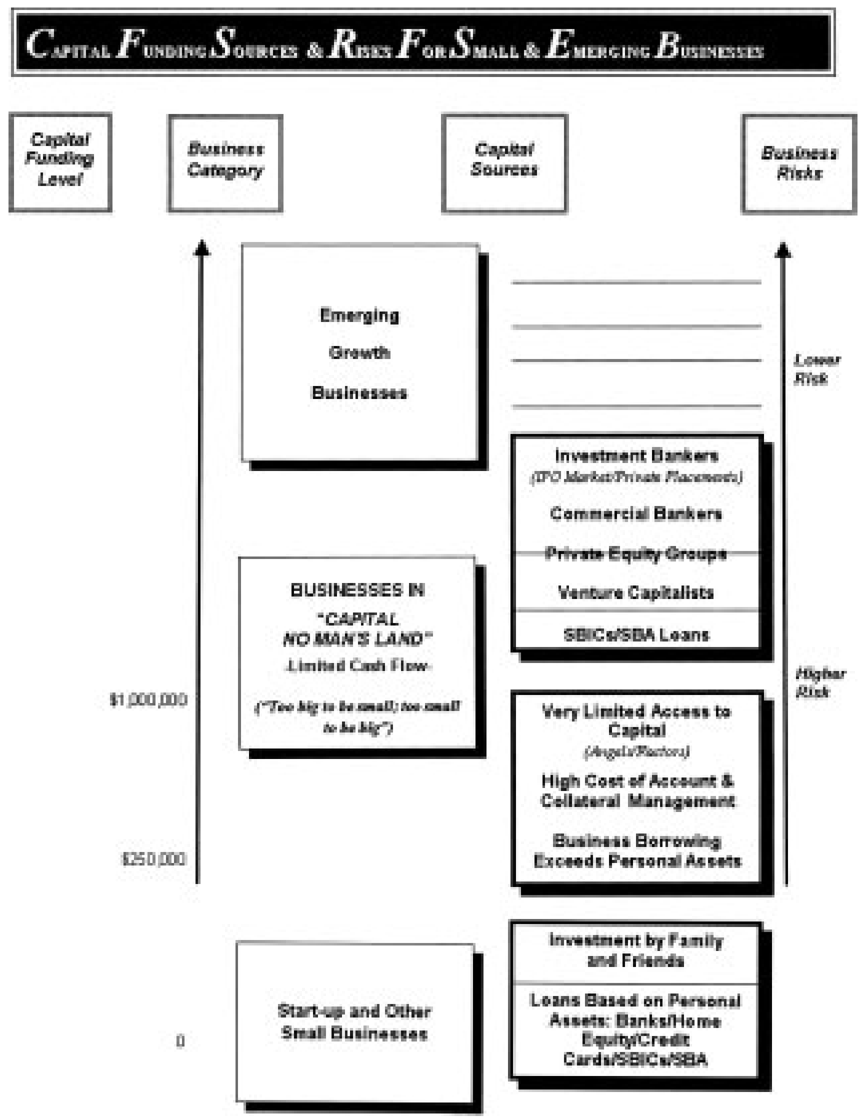
Bridge Act Summary: The Bridge Act would allow a deferral of up to $250,000 in Federal income tax for two years, with payment over a 4-year installment period and with interest paid on the deferral at the Federal tax underpayment rate. Businesses that grow at least 10% in gross receipts above the prior 2-year average would be eligible if they are on accrual accounting for tax purposes and have $10 million or less in gross receipts. The deferred amounts would be placed in a trust account at a bank or other qualified intermediary, for use as collateral for a business loan. The deferral (under H.R. 3062/S. 1903) would be effective for four years, with a GAO study (in consultation with the Treasury Department and Internal Revenue Service).

Capital Needs of Growing Entrepreneurial Businesses: The Bridge Act would provide an efficient source of critically needed capital funding for entrepreneurial businesses to reinvest in continued growth of sales and jobs. Capital funding in the range of $250,000 to about $1,000,000 is very difficult and costly to obtain for growing businesses. Limited capital availability limits the ability of the business to keep expanding sales and employment. A rapidly growing company can grow itself out of cash, unless it can obtain outside financing. The temporary tax deferral would allow the entrepreneur to utilize the funds in the business until it can grow large enough to obtain financing from more traditional sources at a more reasonable cost.

Employment and Economic Growth: By providing needed capital to keep expanding the business, the Bridge Act would assist the entrepreneurial sector (the "emerging growth companies") that has created most of the new jobs in the U. S. economy in the past decade. A Cognetics, Inc. study, *Who's Creating Jobs?* 1999 (David Birch, Jan Gundersen, Anne Haggerty, William Parsons, Cambridge, MA), indicates that 85% of the net, new jobs for 1994–1998 were created by companies with under 100 employees. There are indications that these rapidly growing companies are the only ones that are generating net new job growth in the current economic situation. The bill would help to reinvigorate the economy by offsetting employment cutbacks elsewhere in the economy. The Bridge Act would provide critically needed capital for these companies, which could help create more than 600,000 new jobs during the first three years, based on sample data from financial statements of profitable firms with $10 million or less in sales (database sample provided by Dr. Michael Camp, Economist and former Vice President of Research, the Kauffman Center for Entrepreneurial Leadership, Kansas City, MO.).

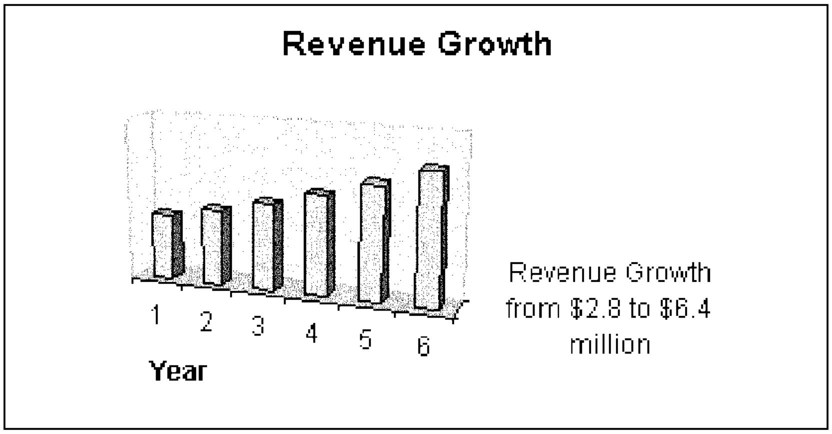
A recent study by the National Commission on Entrepreneurship, *High-Growth Companies*: *Mapping America's Entrepreneurial Landscape* (July 2001), reports that rapidly growing companies (15% or more growth per year in their Census survey for 1992–1997) are in all industry sectors and in all Labor Market Areas in every State in the United States. For State data, see website (www.ncoe.org/lma).

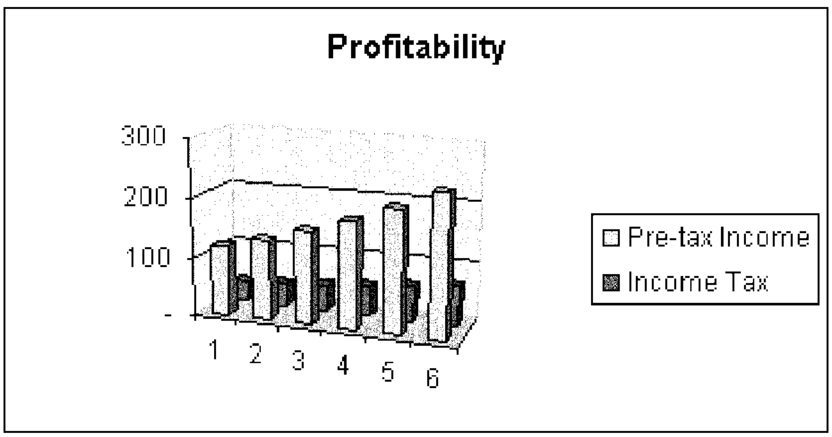
Timing of Income Tax Liability for Growing Small Businesses: Because of the microeconomics of rapid growth, an expanding business on accrual accounting that is experiencing increased revenues and book (accrued) profits can also be simultaneously experiencing negative cash flow due to reinvestment of the cash to fund continued growth of the firm. When a growing business, with negative cash flow, has to come up with immediate cash to pay an accrued tax liability, this can have a severe adverse financial effect on the firm's ability to survive until it receives more cash inflow. The bill would allow the realignment of the timing of the tax payment until the entity can more readily obtain the necessary capital to pay the tax, which would be payable in installments over four years after a 2-year deferral (with interest payable on the deferral at the Federal rate on tax underpayments).

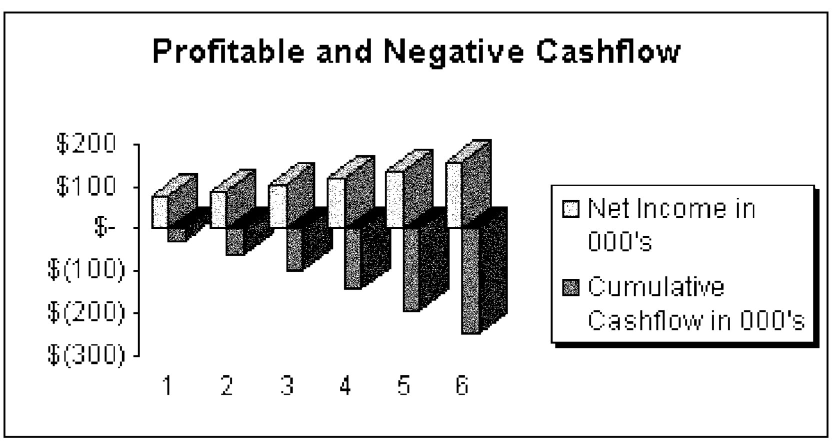


Microeconomics of Growth

The following illustrations were built from an economic model that accounts for the typical asset growth characteristics of a rapidly expanding business on accrual accounting and transitioning through "No Man's Land."


Revenue Growth
1
2
3
4
5
6
Year
Revenue Growth from $2.8 to $6.4 million


Profitability
300
200
100
-
1
2
3
4
5
6
Pre-tax Income
Income Tax


Profitable and Negative Cashflow
$200
$100
$-
$(100)
$(200)
$(300)
1
2
3
4
5
6
Net Income in 000's
Cumulative Cashflow in 000's

Summary Interview Statement of Harden Wiedemann, CEO, Assurance Medical, Inc., Dallas, Texas

In 1998, Harden Wiedemann's Assurance Medical, Inc., a company that outsourced drug-testing services, was on the fast-growth track with clients such as Frito-Lay and Southwest Airlines.

By January 2001, unable to keep up with the capital requirements, Wiedemann was forced to sell Dallas-based Assurance Medical to First Hospital Corporation, based in Norfolk, Va.

Today, Wiedemann shakes his head at the irony of the situation. "It wasn't that the company went out of business. The problem was that we had too much business to service with the resources we had! We had more contracts and demands for services than we could fund out of cash flow.

"We needed several million dollars in working capital to take on AT&T and several other large companies as clients," Wiedemann said. "We had to ramp up the telephone service center, hire more employees—lots of things that required upfront cash."

"I tried everything," he said. "I even looked at factoring. I could not get funding." The company had entered territory known as "No Man's Land," the transitional period when a company is too big to be small, and too small to be big.

"We needed $2 million to $3 million. That was too much for early-stage investors and incubators, and not enough for the venture capitalists," Wiedemann said. "We really beat the bushes. For a full year, that was pretty much all I was spending my time on."

Wiedemann laments that lost year. "It takes you away from the operational aspects of the businesss. Customer service is the reason we got those companies—that started to slide when I couldn't keep my eye on the ball because I was spending all my time trying to find funding."

Wiedemann believes that legislation such as the proposed BRIDGE Act, which would allow entrepreneurial, rapidly growing companies to defer up to $250,000 in federal taxes, might have saved his business if it were in force at the time. "It would have allowed me to ramp up my operation enough to bring those contracts on line, so we could have continued to grow out of internal cash flow. We could have closed the deal with AT&T and several other pending contracts."

He considers the BRIDGE Act solution superior to alternatives such as obtaining a loan through the Small Business Investment Company program. He found that process slow, exasperating and ultimately unsuccessful. "It's unfathomably complicated and bureaucratic," he said.

Frustrated at every turn, Wiedemann decided to re-create the company and transform Assurance Medical into a Web-based application service provider, rather than an outsourcing partner. "We actually had a commitment from a venture capital group. If the migration had panned out, we had a commitment to merge with two other companies and get $5 million. Then the e-commerce market started to erode, the venture capital company pulled out—and I went into high gear trying to sell the business."

The sale cost 20 employees their jobs. But more than that, Assurance Medical lost the opportunity to hire more workers and continue growing. "We could have been as big as 50 to 100 employees and $20 million in sales if we had been able to get interim financing. We were on track to do that," Wiedemann said.

"When times are tough, small business creates the jobs," he concluded. "When you cut off their air supply, it has an economic impact."

"The BRIDGE Act could help businesses survive so they can continue to create jobs." (Interviewed by Tatum CFO)

Summary Interview Statement of Less Walker, CEO, DocuSource, Irvine, California

If capitalization weren't a problem, Les Walker, CEO of DocuSource, would be building his sales organization and aggressively seeking sales throughout Southern California, not just in Los Angeles and Orange counties. "We would be placing sales branches in new marketplaces, signing more customers, hiring more service and field technicians, and even adding administrative support," Walker explained.

Instead, DocuSource has trimmed its staff from more than 100 to only 70 employees, kept its focus largely on LA and Orange counties—and is even considering the sale of the company.

"We're in a vice where there is a tremendous market opportunity, but we're not in a position from a capital standpoint," Walker said. "Instead of increasing revenue and employment, we're reducing our workforce so we can work within the realities."

DocuSource should be on top of the world.

Consider: The fast-growth office equipment company has grown 700 percent over the past eight or nine years, to more than 100 employees and $21 million in sales in 2001. It was ranked 159 in 1995 on *Inc* magazine's annual list of 500 fastest growing companies. The *LA Business Journal* has counted it among the fastest growing private companies in Los Angeles for six consecutive years. Although clients are primarily from Southern California, its national accounts include the prestigious CB Richard Ellis.

"We are a good example of an emerging growth company that has the ability to compete and provide alternative solutions to the largest players in our industry," Walker said. "Our challenge is capitalization in order to sustain our level of growth."

Walker indicated that the BRIDGE Act would have been helpful to his company and others like it that are profitable but cash-poor. "If we had had $250,000 in deferred income taxes that could be treated as capital from the bank's perspective, it would have cut our debt to equity ratio in half. We would suddenly have become a very bankable company. That would have had a tremendous impact on our ability to continue to grow the company and provide jobs."

Instead, Walker said, the company's current bank increasingly is cutting back on the firm's borrowing power. "We're in a cash stranglehold with the current lender." Efforts to negotiate a line of credit from a replacement bank have been unsuccessful. "Banks have tightened up their underwriting criteria," he said.

DocuSource has been equally unsuccessful in its efforts to raise $1 million in subordinated debt. "We offered a 20 percent annual interest rate, and at this point have only raised about 40 percent of what we need, with half of that total coming from the owners."

Incorporated in 1990, the company ran into trouble in 1998, when it expanded its product line and its marketplace. From a one-product company in the Los Angeles County marketplace, it began to offer three product lines in a territory that included seven Southern California counties.

The catalyst was Ricoh Corp.'s development of the first digital copier, which it sold through authorized dealers such as DocuSource. DocuSource seized the opportunity to sell the latest and best technology to a broad range of customers. The drawback: "It took a tremendous amount of investment to bring it on. We had to train the sales staff, train or hire field service technicians, and expend capital to inventory the equipment, parts and supplies."

"There's no question. If we had additional capital, we would build our sales organization and become aggressive with the other Southern California counties; we would be placing sales branches in those marketplaces," Walker said.

Instead, DocuSource is reluctantly considering the sale of the company, which would undoubtedly lead to layoffs. "The acquiring company probably does not need all the infrastructure that we have—which means that the economy would be better off with us as an independent company than if we're acquired and duplicate personnel are laid off."

(Interviewed by Tatum CFO)

Summary Interview Statement of Eliot Weinman, entrepreneur, Shrewsbury, (Worcester area), Massachusetts

Eliot Weinman has started two fast-growth companies in the past 12 years, ramped them up to several million dollars in revenue—then was forced to sell both of them when capital needs outstripped cash flow.

Weinman established the first company, Software Productivity Group, in 1989, working from his home. "We produced magazines, ran conferences and performed analyst consulting services," he said. "Our clients were large companies that were buying enterprise software and software development tools."

In 1990, the company's revenues totaled about $100,000. By 1993, the total had grown to $2 million and, by 1995, $3.8 million. By the time the company was sold in March 1996, it numbered about 25 employees.

"It all sounds great," Weinman concedes. "The problem is that, when you're growing, you've got to pay your payables. You can't push them more than 60 days." And Software Productivity Group's payables—primarily for printing and postage—were substantial. By contrast, cash receipts from accounts receivables were taking three to six months to come in.

"Then there are taxes," said Weinman. "We were in the 40-percent tax bracket after the third year."

If the BRIDGE Act had been in force at that point, Weinman could have put the deferred taxes to good use. "When a business is growing, you've got critical cash-flow needs. I wouldn't have minded paying taxes later—I would definitely have been

able to hire more people, have grown more and, in the end, generated more revenue and profits, and thus, would have ended up paying more taxes to the IRS."

By the end of 1995, Software Productivity Group had grown to 25 employees, had moved into a new office in June 1995, and was generating almost $4 million in revenue. "We were on track to do almost $6 million in 1996."

It wasn't to be. "I needed to increase magazine circulation at a cost of over $400,000, expand and move the office again, and hire more people. The tax bill was going to be more than $300,000, and we needed working capital of at least $200,000. Since January and February are typically slow months in our business, we also had to fund about $150,000 in overhead through March 1996. Although I had set up a $100,000 revolving line of credit, I couldn't successfully grow my company on what was left," Weinman said.

At that point, Software Productivity Group was approached by Ullo International, a privately held rollup company. "Ullo was prepared to cash us out and invest $1 million in the company," said Weinman, who accepted the deal, albeit reluctantly. "If we had been better capitalized, I would have kept the business," he said.

Weinman founded another company in late 1997, with Intermedia Group, a high-tech conference and consulting business. This time he accepted $300,000 in venture financing from META Group, a publicly held company (Nasdaq: METG). On reflection today, Weinman said he might not have gone that route if the BRIDGE Act had been on the books as a potential option once his company achieved a measurable fast-growth position.

One again, the company grew rapidly. It did $450,000 million in revenue in 1998, $1.9 million in 1999, and $6.2 million in 2000.

"We were a nice-sized company, doing business across the country. We had about $1.3 million in cash by the end of 2000."

However, this was barely enough to fund the fast-growing company's needs. Intermedia paid $750,000 in taxes and $300,000 in expenses during the slow months of December through February. It also had to begin funding the marketing expenses for the March and April conferences. With no conferences planned early in the year, income was minimal the first quarter. Weinman was left with about $250,000 in the once-hefty bank account. "A quarter of a million in deferred taxes would have given us an important buffer," Weinman said. He added, "Half a million dollars would have been even better."

"If you have a quarter million, you can hire up to three or four people and begin funding the marketing expenses needed. That carries the growth you had in 2000 into 2001 and accelerates your business a great deal."

Again, with cash needs of at least $250,000-$500,000, Intermedia Group was a target for a takeover. "When you are growing quickly in the $1 million-to-$10 million range, you start to compete with larger companies very quickly. Our competitors on the low end were $30 million to $40 million conference companies. On the high end, we were also competing with large, traditional information technology publishing companies whose annual revenue was greater than $1 billion.

Instead of continuing to grow as an undercapitalized business, Weinman accepted an offer from Internet.com (now INT Media Group, Inc., Nasdaq: INTM) to buy Intermedia.

Weinman adds, "Another benefit to the Bridge Act would be, as an entrepreneur, you could pay yourself a little more. I was pulling a salary of $30,000 at Software Productivity Group for several years. Some would-be entrepreneurs can't afford to do that. If an entrepreneur could pay himself or herself $60,000, it would provide more incentive to go into business, and then stick with it."

"I believe it's better for a small company to grow big and succeed than to get sold. I would rather have a business. I think most entrepreneurs would."

(Interviewed by Tatum CFO)

Summary Interview Statement of Ed Rankin, CEO, PeopleSolutions, Inc., Dallas, Texas*

If the BRIDGE Act had been in force when Ed Rankin's human management resource company began its rapid growth in 1996, things might have been different.

"If we had an extra $250,000 at several points in our growth, that would have meant the difference between night and day," said Rankin, founder and CEO of PeopleSolutions®, Inc.

"When you're a new business, you haven't earned the right to have people pay in advance. They pay once you've billed them for the work. I might have to pay my

*See Also statement of Ed Rankin, before the House Small Business Subcommittee hearing on June 26, 2001.

people two, three or even four times before receiving the first payment from the client. We were always behind in cash flow."

The first cash crisis occurred as PeopleSolutions, Inc. entered its third year of operation, a period of unprecedented growth. "Our clients, predominately large, U.S.-based multinational corporations, were asking us for more and more services. We were profitable. We were ranked among the 25 fastest growing companies in the Dallas-Ft. Worth area.

"And we had no cash."

Undercapitalized and delinquent on taxes, Rankin was forced to sell its receivables, at a discount, to an unregulated lender at high rates. "I had no choice. I sold my receivables, collected my cash, paid the IRS, and stayed in business.

By 1997, things were looking up. "We had very strong gross profit margins and a backlog of receivables from a growing list of blue-chip, Global 1000 clients." A newly opened office in Austin became profitable in 90 days. The company was again ranked among the 25 fastest growing privately held companies and among the 100 fastest-growing owner-managed businesses in the Dallas-Ft. Worth area. Revenues totaled $3.8 million.

"A large regional bank extended us a credit line to finance our receivables and a working capital loan, which was used to pay off some equipment leases and release us from the factoring agreement."

In 1999, *Inc* magazine ranked PeopleSolutions among the 500 fastest-growing companies in the United States. But cash flow was once again a problem, and Rankin began to consider selling the business. The newly merged bank complicated matters by rejecting a request to increase the company's credit line, and then forcing PeopleSolutions into the bank's factoring division, saddling the firm with an onerous repayment schedule. "We had no cash to grow. It was all going back to the bank," Rankin said.

PeopleSolutions was rescued later that year by a Small Business Investment Company (SBIC) lender. PeopleSolutions accepted a deal for $1 million in subordinated debt, which allowed it to grow from $4 million in 1999 to $6.5 million the following year.

Rankin is convinced that the BRIDGE Act not only would have lessened his woes considerably—it would also have accelerated PeopleSolutions' growth.

"If we had been able to take advantage of the tax deferral provisions of the proposed Bridge Act, I believe that the company would be at least twice as large as we are today," Rankin said. "We would have added more people, who would be paying more employment taxes. And there's no question we would have created more jobs."

(Interviewed by Tatum CFO)

Statement of the U.S. Chamber of Commerce

The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 71 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business—manufacturing, retailing, services, construction, wholesaling, and finance—numbers more than 10,000 members. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 94 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. Currently, some 1,800 business people participate in this process.

The U.S. Chamber of Commerce appreciates this opportunity to express its views on the President's Jobs and Economic Growth Plan. The U.S. Chamber is the world's largest business federation, representing more than three million businesses and organizations of every size, sector and region. This breadth of membership places the Chamber in a unique position to speak for the business community.

THE ECONOMY AND THE PRESIDENT'S JOBS AND GROWTH PLAN

Recently released data show the U.S. economy to be one that is still searching for confidence, balance, and momentum. Real GDP growth during the most recent 5-quarter period has averaged only 2.9%, insufficient to consistently generate new jobs. Indeed, over this time span, the U.S. economy has lost about 1.3 million jobs. Moreover, many economists have trimmed their forecasts for first half growth. Although some recent monthly data show enough incipient signs of improvement to keep the nation hopeful that the economy will accelerate in the future, policy initiatives are clearly warranted. With the Fed having cut interest rates about as far as possible, fiscal policy appears to be our only remaining choice. Fortunately, the President has proposed a bold program for economic growth that includes a host of proposals, including significant tax cuts, creation of broad new savings and retirement vehicles, targeted tax incentives, and permanent repeal of the insidious "death tax."

The keystone of the President's program is his Jobs and Economic Growth Plan—a package of tax cuts designed to boost consumption and encourage investment. This proposal would accelerate marginal tax rate cuts, marriage penalty relief, the increase in the child credit, and the expansion of the 10 percent bracket passed in his landmark 2001 tax bill; enhance Section 179 capital asset expensing for small businesses; and eliminate the double taxation of dividends. This is a well-balanced package that will increase economic growth, both in the near term and for the long run.

The White House understands that the biggest need of American businesses large and small, and in all sectors and regions, is customers with the will and the means to spend. Moreover, the best way to boost consumption is to increase disposable income and wealth. The President proposed a number of tax cuts that were passed by a bipartisan Congress in 2001, but were delayed full implementation for budgetary reasons. If these cuts were good policy then, they are even better policy now. Marginal income tax rate cuts, expanding the size of the 10 percent rate bracket, fixing the marriage penalty, and increasing the child credit will put more disposable income in the hands of American consumers immediately.

The President's expansion of the lower income tax brackets makes the 10 percent bracket applicable to more income, which benefits all individuals who pay U.S. income taxes—and makes the 15 percent bracket applicable to more income of married couples. These measures will put more money in the hands of those most needing and prone to spend it, thus cycling it back into the economy, where it will do further good.

This proposal is also good for business. Many smaller businesses are organized as flow-through entities, such as S corporations, whose owners pay taxes at the individual rates. They will see an immediate cash flow benefit from the lower marginal rates. The Section 179 expensing provision will both triple the maximum deduction and introduce enhanced phase-out levels, stemming the erosion in the value of depreciation deductions that would otherwise occur over time. This, in turn, will further augment current cash flow and encourage and enable these companies to invest in new machinery and equipment, increasing their productivity and providing a further boost to the economic sectors that produce and service those items. In sum, these funds will be used to grow businesses and create new jobs.

One of the most misunderstood and maligned, but nonetheless important, pieces of the President's package is the elimination of double taxation of dividends. When a business earns profits, those profits are subjected to corporate income tax. When those profits are subsequently distributed in the form of dividends, they are taxed again at the individual level—resulting in a second layer of tax on the same income. The President's proposal would allow corporations that have already paid tax on their profits to distribute those profits without further taxation on those same dollars.

This piece of the package has received the most criticism, unjustly and erroneously challenged by some as an unnecessary and inefficient giveaway to the rich. Over 50 percent of Americans own stock and many of these stockowners are elderly retirees who must live off the proceeds of their lifetime of investments. It is simply

unfair to tax them twice. Removing the inequity will leave more American taxpayers more of their hard earned money, and they will spend it, stimulating the nation's economic growth.

While the direct benefits go to stockholders, indirect benefits will accrue to the entire economy. Removing the double tax will increase after-tax rates of return on investments, bolstering stock prices and lowering the cost of capital. Businesses will invest more, boosting economic growth and creating more jobs. While raising stock prices is not the main intent of the dividend proposal, we should not overlook its importance. Stocks are a major component of wealth and any improvement to beleaguered stock prices will surely help to mitigate the negative wealth effects of the last couple of years.

Elimination of the double tax on dividends will have important salutary effects on corporate governance. Under tax law, debt financing has traditionally enjoyed a marked advantage over equity financing. While a distribution in repayment of debt financing allows for corporate tax deductibility of its interest component, a distribution of the return on equity financing, a dividend, does not. Put another way, corporate income that is associated with payment of interest is taxed only once—to the payee—as it is fully deductible to the corporation against that income. This is in clear contrast to the dividend, in which the corporation is fully taxed on the associated income and receives no deduction for the corresponding payment, while that income is fully taxed *again* to the recipient. This inequity disfavors equity financing, and results in tax-inefficient allocation of resources.

Likewise, this causes an undesirable "whipsaw" effect. While payment of the return on equity financing, i.e., dividends, is subject to a tax disadvantage, corporations have routinely been permitted to hold onto their reported earnings, rather than being called upon by their stockholders to distribute them. Under current tax law, many of these stockholders enjoy a tax advantage by letting these dividends accumulate, thus boosting the worth of the company and the associated stock prices, which gives rise to more advantageous capital gains taxation when the shares are sold. Under pressure to buoy stock prices, corporate managers are more than happy to assent, and may become prone to "manage" corporate earnings—occasionally creatively—in an attempt to maximize them. At the same time, the gross inequity between dividends and interest may cause a run-up of debt in relation to equity, which some have credited with making the corporation more susceptible to default and bankruptcy.

Elimination of the double taxation of dividend income will improve corporate governance by alleviating these inequities. Removal of the shareholder's incentive to let managers blindly accumulate or hoard corporate income will bring those earnings under closer scrutiny. In some cases, shareholders will demand distribution of some of those earnings, which will keep management more honest about their financial reporting, because while irregularities in reported earnings can sometimes evade detection for awhile, non-receipt of a dividend check is more easily and quickly recognized. Furthermore, the President's plan would allow an increase to the shareholder's stock basis for corporate income which could otherwise be distributed as tax-free dividends, but which is accumulated. Both the shareholders and IRS will get annual notification of these increases, hence more scrutiny. In all, the plan will create more transparency, make corporate earnings easier to monitor, and place equity financing on an economically healthier, more equal footing with debt financing.

The President's plan also preserves the benefits of the foregoing provisions against encroachment by an antiquated Alternative Minimum Tax (AMT)—a tax that is increasingly hurting the middle class. Protection is provided to both single and joint filers via a limited amount of relief against the increase in AMT that would be automatically levied on taxpayers due to these tax changes.

While businesses and the workforce are mobilizing for recovery and growth, the President's Personal Reemployment Accounts will assist many of those who are trying to recover from the economic downturn. These accounts will give a helping hand to people while attempting to find reemployment by giving them up to $3,000 to use for job training, child care, transportation, or to defray the costs of relocating. And the help doesn't necessarily stop there. As an added incentive, if a job is obtained within 13 weeks, the worker would be permitted to keep any unused funds remaining in the account.

CONCLUSION

The economic implications of the President's Jobs and Growth Plan are huge. Economic simulations done by the Administration suggest that passage of this package could boost real economic growth in 2003–2004 by 0.8 to 1 percentage point per year and create 500,000 to 900,000 new jobs each year. Numerous private sector simulations have also been run to project the effects of the president's package on real

GDP and employment growth. One private simulation concluded that passage of the package would yield an additional 0.5 to 1.0 percentage points of real GDP growth and 242,000 to 894,000 new jobs over 2003–2004. Another study found even greater positive results, projecting an additional 0.5 to 1.8 percentage points of real GDP growth and 800,000 to 2.9 million new jobs.

Even with these predictions of positive benefits, detractors have contended that these cuts are not needed. They claim that the economy is picking up steam on its own and that we don't need a tax cut that will increase budget deficits already swollen with additional spending for homeland security and war in Iraq. We believe they are wrong on both counts. The economy is growing, but it is still well below its potential. A well-designed tax cut is sound insurance—especially given the current geopolitical uncertainties—and good long-term public policy. As for the deficit issue, the best way to address the deficit is to control federal spending and lift economic growth to its job-creating potential with the President's timely, well-balanced tax plan.

In sum, this plan is just what we need.

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